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BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION

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PURPOSE

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

(Art. 2) The Foundation, International Bureau of Fiscal Documentation, established as a foundation of the International Fiscal Association (hereinafter referred to as I.F.A.) shall strive towards a fruitful cooperation with the I.F.A.

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

L'OBJET DU BUREAU

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

(Art. 2) La Fondation, Bureau International de Documentation Fiscale, instituée comme fondation de l'Association Fiscale Internationale (ci-après désignée I.F.A.) s'efforcera d'établir une coopération fructueuse avec l'I.F.A.

Les objectifs de la Fondation sont d'établir et assurer le fonctionnement d'un bureau de documentation international dans le but de diffuser des informations concernant la législation fiscale et l'application des lois fiscales, et de faire progresser la recherche en matière d'imposition.

(Art. 3) The Foundation shall endeavour to achieve these objectives:

a. by setting up a library of tax legislation, together with relevant books, journals and other publications;
b. by supplying detailed and general information;
c. by allowing the inspection of works acquired by the library, with the permission of the director and subject to the conditions imposed by him (which may also be of a financial nature);
d. by producing publications;
e. by cooperating with the publications of others;
f. by all other lawful means.

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

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

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

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

(Art. 3) La Fondation s'efforcera de réaliser ces objectifs:

a. en constituant une bibliothèque de législation fiscale, ensemble avec les livres s'y rapportant, des revues et autres publications;
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Le Bureau publie aussi *European Taxation,* revue mensuelle sur les systèmes fiscaux européens. *Tax News Service,* publié deux fois par mois, donne une information rapide, à l'échelle mondiale, de tout ce qui touche à la fiscalité. *Supplementary Service to European Taxation* est un ouvrage de référence présentée sous feuilles mobiles.

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

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

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The list of addresses of the major publishing houses which appeared on page 47 of the January issue of the *Bulletin* indicates an incorrect address of Price Waterhouse. The correct address is: 1251 Avenue of the Americas, New York, New York 10020, U.S.A.

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TAX TREATY SHOPPING

By Joseph H. Guttentag

This article contains comments by Mr. Joseph H. Guttentag, Arnold & Porter, Washington, D.C., U.S.A. on the subject of "treaty shopping".

The author was a member of the panel which discussed Subject I: Tax Avoidance/Tax Evasion at the 1983 Congress of the *International Fiscal Association*, 10-14 October 1983 in Venice (Italy).

The terms "treaty shopping" or "abuse of conventions" are obviously pejorative terms. I suggest that we begin our discussion using a longer but more neutral description of the subject, that is, the extent to which non-residents of a treaty country can and should be allowed to benefit from the tax treaty of that country. The U.S. Treasury Department also avoids the pejorative terms and uses the phrase "limitation of treaty benefits". A Treasury official recently described the problem as the single most important international issue with which the Treasury is presently dealing.

Third country residents have used tax treaties in this fashion for many years, but only recently have the government officials responsible for treaty negotiations begun to focus on this issue and comment on it both publicly and privately, and organizations such as the OECD and the International Fiscal Association begun to discuss the issue.

Many of the National Reporters[1] indicated that treaty shopping was not a problem and their treaties did not deal with the issue (e.g. Argentina, Australia (but see new U.S./Australia treaty), Denmark, Finland, Indonesia, Israel, Italy, Japan, Luxembourg and Sweden). On the other hand, the issue has been addressed in recent treaties entered into by the Netherlands, Switzerland, the U.K. and the United States. The Hong Kong Reporter notes that Hong Kong has no treaties and residents may often use third country treaties for outbound investments which are not of concern to the fisc.

In order to understand the issue, it would be useful to review briefly the history of this problem over the years. This is not a new problem and through treaty negotiators have not focused on the issue, related issues have been covered by tax conventions.

The issue originally arose and was dealt with in the treaty provisions defining a "resident" of the treaty country. In general, treaty benefits have been limited with some exceptions to residents of the treaty countries. The definition of resident varied from treaty to treaty although the treaties were generally written or interpreted to define a resident and therefore a person entitled to the benefits of the treaty as one who is taxed as a resident on world-wide income by a treaty partner.

Since the United States has been the most active recently in suggesting resolutions to this problem (though many other countries have seen the problem and dealt with it in various ways), it might be useful to consider how the United States has dealt with this in its treaty negotiations.

The old convention between the United States and the United Kingdom was amended by a supplementary convention in 1966 to deal with the then existing U.K. remittance system. Income realized by U.K. residents from U.S. sources and otherwise entitled to reduced rates or exemptions would not be entitled to the benefits of the convention if the income was not "subject to tax" by the United Kingdom because the income has not been remitted to the United Kingdom. A similar change to deal with a related but different problem in Canada was also negotiated by the United States so that Canadian corporations which were not managed and controlled in Canada under Canadian municipal law and therefore not subject to tax were denied treaty benefits – even though the corporations were organized and created under Canadian law. During the same period the United States was negotiating a treaty with Luxembourg. Luxembourg law provided for exemption from tax for certain Luxembourg holding companies. The Luxembourg treaty contained a unilateral provision denying treaty benefits to Luxembourg companies which qualified for this holding company relief. Every Luxembourg treaty now contains a similar provision.

The second phase of this problem was generated as a result of the extension of the U.S. treaties to colonies and dependencies of certain treaty partners, principally the United Kingdom, the Netherlands, and Belgium. The Netherlands treaty had been extended to the Netherlands Antilles in 1955. As we are well aware, the Netherlands Antilles while imposing a substantial income tax provides reduced taxes for certain companies.

As an aside we should note that many of the problems which the United States faces in connection with its treaties, including the extensions to the British Virgin Islands and the Netherlands Antilles, result from what now appears to be an incautious extension of U.S. treaty benefits to dependencies and colonies, some of which then became independent, without a thorough examination of the internal laws of those countries and the purpose served by an extension. The United States has now dealt with that problem by notice of termination of 30 June 1983 of the extension of U.S. treaties to 18 present or former dependencies or colonies.

With respect to the Netherlands Antilles, the treaty relationship as it existed before 1965 permitted third country residents to take advantage of the treaty, pay Netherlands Antilles corporate tax, which generally does not exceed 3%, and remove the income from the Netherlands Antilles without any further tax because the Netherlands Antilles does not impose any withholding taxes. The 1963 solution to the Netherlands Antilles problems involved limiting the treaty benefits through some very

1. See *Cahiers de droit Fiscal international* / Studies on international fiscal law, Vol. LXVIII a, Tax Avoidance/Tax Evasion (1983), General Reporter Professor V. Uckmar.

complicated and somewhat inconsistent provisions. Certain treaty benefits were denied if the Netherlands Antilles corporation was not owned by residents of the Netherlands or the Netherlands Antilles or if the Netherlands Antilles corporation was entitled to the benefits of the substantially reduced corporate tax rates. The denial of benefits extended to the reduced rates of tax or the exemption provided with respect to U.S. source income and did not extend to the treaty as a whole. For example, following the 1963 protocol, a Netherlands Antilles corporation, which was owned by non-residents of the Netherlands Antilles or the Netherlands, could take advantage of the permanent establishment article of the Netherlands treaty as well as the provisions which prohibited the imposition of U.S. withholding tax on dividends or interest paid by Netherlands Antilles corporations or persons other than the U.S. citizen or resident. Furthermore, there was no provision dealing with the common situation involving payment by a Netherlands Antilles corporation of a substantial portion of its income in the form of deductible items so as to limit the generally applicable Netherlands Antilles tax to amounts often less than if the special holding company provision applied. Despite the amendments made with respect to the Netherlands Antilles/U.S. treaty relationship, the Netherlands Antilles became an increasingly important vehicle for investments in the United States, particularly with respect to U.S. real estate and also for Eurodollar borrowings by American companies. The Netherlands Antilles remains today the only practical window for Eurodollar borrowings which poses a significant problem in the renegotiation of that treaty relationship which is presently taking place.

The third phase of the development of this issue took place in the late 1970s, involving among other negotiations those with Cyprus, the British Virgin Islands, the United Kingdom, and the new U.S./Canada Treaty. Also in 1977, the United States released a new model treaty which contained a more thorough and complete limitation of benefits article. Each of the limitation provisions was tailored to the problems as perceived by the treaty negotiators. The perceived problems and the U.S. attack on them were escalating rapidly. The principal U.S. concern appears to be that the use by third country residents of existing treaties impairs the ability of the United States to negotiate or renegotiate treaties with the country of such residence. In fact, the Treasury Department under the new Reagan Administration signed a treaty with the British Virgin Islands early in 1981, only to withdraw that treaty from Senate consideration later the same year on the grounds that the limitation of benefits article was not stringent enough. This leads us then to the fourth phase, involving the release by the Treasury of its 1981 U.S. Model Treaty provision, followed by a further discussion draft of Article 16 dealing with limitation of benefits in December of 1981.[2]

Before proceeding to a detailed discussion of limitation of benefits, we should focus on the issue of who should be entitled to the benefits of the tax convention. As previously indicated, the benefits are generally limited to residents of a contracting state. In some cases a convention explicitly or implicitly extends the convention to non-residents. For example, under the proposed U.S./Canada convention, certain governmental employees, who are resident in a third state but nationals of one of the contracting states, are deemed to be residents of the employing contracting state. Additionally, the presently existing U.S./Canada Treaty prohibits either the United States or Canada from taxing dividends or interest paid by a company resident in the other state to persons not resident or citizens of the taxing state, thereby implicitly extending treaty benefits. Canada, for example, under other treaty relationships has also recognized that non-residents can be the beneficiaries of Canadian treaties. A Canadian court has held that dividends paid by a corporation organized in, and therefore resident in, Canada, but also resident in a treaty country under the treaty provisions, could not be subjected to Canadian tax when paid to a resident of the third country even though such tax would be imposed under Canadian domestic law.[3]

Let us look at some specific examples. For this purpose, we use Country A in which Company A is resident. Country A has a treaty with Country B in which Company B is located. Company C is located in Country C. Country C does not have a treaty with Country B or with Country A.

Let us look at 5 examples:

Example 1 – Company B is owned 80% by individual shareholders who are individuals resident in Country B, and 20% by Company C, all of whose shareholders live in Country C. Company B is solely a holding company and among other investments has a subsidiary in Country A which benefits from the Country A/Country B treaty.

We must look at the criteria which were assumed in connection with the example. Under Example 1, should it matter if Company C owns, instead of 20%, 25%, 50%, 75%, or 100% of the stock of Company B? Is the tax regime in Country B relevant? Assume that Country B's and Country A's tax regimes are identical. In this case, Company C may be no better off if all earnings are distributed than if it had invested in Country A through a subsidiary, Company A. However, there is a transfer of revenue from Country A to Country B because Country B benefits from the tax reductions provided under the applicable tax treaty.

If Country B taxes are lower, then some benefits may flow to Company C. There can either be a reduced company tax or a reduced withholding tax on payments made from Company B to Company C. In such a case, Company C and its individual shareholders may benefit from the Country A/Country B tax treaty even though there is no tax treaty between Country C and Country A, and even though Country C did not have to make any concessions to Country A in order to obtain the benefits of the reduced withholding taxes.

Furthermore, since Company C and the residents of Country C may take advantage of the Country A/Country B tax treaty, the incentive for Country C to enter into a tax treaty with Country A is substantially reduced.

2. See Appendix A for these provisions and other examples of treaty articles designed to deal with this problem.
3. *Hunter Douglas, Ltd. v. The Queen,* [1979] CTC 424; 79 DTC 5340 (FCTD).

Example 2 – Company B is owned 100% by residents of Country C and engages in the manufacturing business in Country B. Company B has a subsidiary in Company A and the Country A/Country B tax treaty provides benefits to Company B.

Example 2 describes the structure of a typical multinational corporation. The structure of such entities is often influenced by tax considerations, including the existence of tax treaties. The United States, in one of its versions of the limitations of benefits article, would provide an exception to the limitation with respect to the organization of an entity which did not have as a "principal purpose, the obtaining of treaty benefits". While the U.S. Treasury has explained that this language was designed in order to permit companies which would otherwise be subject to the limitations to prove that they should not be so subject, the language creates substantial uncertainty and we suggest unnecessary uncertainty. Example 2 indicates that Company B is engaged in actual manufacturing operations. It is often desirable for multinationals to create companies which are not engaged in such substantive business activities, but may act as holding companies, management companies, or service companies. Furthermore, within the recent past, we have seen a growth of international joint ventures. Two or more businesses based in different countries may wish to enter into a joint venture and, for that purpose, might find it desirable to select a neutral country for the incorporation and residence of the joint venture. The joint venture company may operate in dozens of countries through affiliated companies and should not be denied the benefits of the tax treaty network of the country of residence, even though a principal consideration in selecting the treaty country may have been the existence of a network of tax conventions.

The limitation of benefits or treaty shopping provisions as enunciated by the United States continue to emphasize the bilateral nature of the treaty network. The bilateral treaty network results not so much from a determination of its appropriateness, but from our inability today to solve the complex issues which arise in attempting to devise a multilateral treaty. The OECD and other regional and international groups have noted the desirability of multilateral treaties, but, after many years, have been unable to solve the technical, procedural and political problems. The United States has attempted unsuccessfully in the past to negotiate multilateral treaties with certain African and Central American countries. We should not allow the emphasis on the bilateral nature of tax treaties to interfere inappropriately with international trade and investment, which is not organized on a bilateral basis. The hundreds of tax treaties that are in place and which have operated for many years to facilitate international trade and capital flows have done so prior to the adoption of limitation of benefit rules, such as those proposed by the United States. One result is that these flows move through the bilateral treaty network. Our treaty negotiators and the structure of multinational companies have always assumed, for example, that the French subsidiary of an Italian company will be entitled to the benefits of the French treaty network. The OECD and its members have continually taken the position that a network of treaties operates as an inducement to economic development. This perspective is an important and legitimate consideration to be taken into account in determining which investments or transactions should or should not be accorded treaty benefits. This is not to argue a treaty should be a mere conduit for investment, but that a general rule limiting treaty benefits that is based solely upon a "bilateral" premise may be both unrealistic and unworkable.

Example 3 – Company C deals extensively with Company B which is a bank and Company C uses the bank for its worldwide operation. Company B loans funds to Company A, a subsidiary of Company C, and benefits from the Country A/Country B treaty.

Example 4 – Company A desires to borrow funds. It establishes Company B which borrows funds in Country C and relends them to Company A. Interest income paid by Company A benefits from the provisions of the Country A/Country B tax treaty.

Example 5 – Company C desires to loan funds to its subsidiary, Company A. It deposits funds in Company B, a bank, and Company B then makes a loan to Company A, secured by the deposit. The interest paid by Company A is entitled to benefits under the Country A/Country B tax treaty.

Examples 3, 4 and 5 indicate a range of transactions of increasing likelihood that it may be desirable to restrict the benefits of the tax treaty. The question arises at what point should this be done? Example 4 describes the typical manner in which U.S. companies borrow funds in the Eurodollar market through the Netherlands Antilles, taking advantage of the extension of the U.S./Netherlands Treaty to the Netherlands Antilles, a matter which has been subject to extensive negotiations between the United States and the Netherlands Antilles. Example 5 describes a situation which may be denied treaty benefits even without a specific limitation of benefits article, but under appropriate circumstances pursuant to the requirements of the OECD Model Treaty, which requires that a recipient of the interest income be the "beneficial owner" of the income. Many countries would take the position that under Example 5, depending upon all the facts and circumstances, Company C, and not the bank, Company B, is the beneficial owner of the interest being paid by Company A. In some cases failure to disclose the relationship between Company C and Company B would be regarded as tax evasion or tax fraud by Country A.

We may modify the examples so as to create an entirely new set of problems by changing the assumptions so that we assume that there is a tax convention between Country C and Country A. Under such circumstances, should there be a difference in result? One of the earlier versions of the limitation of benefits article proposed by the United States provided that the limitation of benefits article would not apply under circumstances in which the third country resident resided in a country which had a treaty with the United States which provided substantially similar benefits. The so-called derivative treaty exception to the limitation of benefits article provides an appropriate exception to the limitation of benefits article, but may become extremely complicated in practice. The definition of "substantially similar" may create administrative problems. It is possible to eliminate that requirement and provide an overall exception to the limitation of benefits article if there exists a treaty between Country C and Country A. If Company B is owned by residents of Country C, Country A might provide that the treaty benefits granted to Company B will be limited to the lesser of the benefits granted under the Country A treaty with Country B and the Country A treaty with Country C. Further question arises as to whether this should apply to all provisions of the treaty. For example, should Country A look to the definition of permanent establishment in the Country B treaty and the Country C treaty? It may be very difficult to administer such a rule. Further complications are created if there is a whole chain of companies located in different countries. The treaty benefits may be limited to the lesser of a whole series of treaties. Additionally, if there is a non-treaty country within the chain, should the limitation of benefits article automatically be applied even though the ultimate beneficiary of the treaty benefits is a resident of one or more treaty countries? A question also arises as to whether, in negotiating such a limitation of benefits article between Country A and Country B, which may result in granting or taking away benefits to companies of Country B which are owned by residents of Country C or other countries, these countries should be consulted during such negotiations.

Country C would have an interest in the extent to which benefits are granted by Country A, particularly if the Country C residents created a Country B subsidiary with the purpose of avoiding or minimizing Country C tax. Is this issue more appropriately handled unilaterally by Country C's adoption of appropriate municipal rules dealing with the taxation of income earned by companies owned by residents but located in tax haven countries, such as the rules adopted by the United States, Canada, Germany, and Japan, and discussed earlier in this session? On balance, it would appear more appropriate for the negotiations to be limited to Countries A and B and that Country C should handle this matter unilaterally. It would not appear appropriate for Country A and Country C to limit the benefits under the Country A/Country B tax treaty in those cases in which Company B is owned in part or in whole by residents of Country C.

The United States has retreated substantially from the position previously taken, as described in the United States report, and which proposed a very broad limitation of benefits article. The new U.S. position is much more in accord with the positions taken by many of the European countries as exemplified by the Swiss and Netherlands agreements with the United Kingdom limiting the benefits with respect to Advance Corporation Tax.

There are very broad limitation of benefit provisions in recently negotiated treaties between the United States and Australia and New Zealand. These provisions may be of little practical significance because of the internal tax structures of the countries involved. The United States recently negotiated a protocol to a proposed new tax convention with Canada which amended a very broad limitations article by targeting it to specific perceived possible abuse situations.[4] It is understood that similar provisions will be included in other treaties presently being negotiated but the details of which have not been released by the United States.

In summary, the manner in which these issues have been dealt with by many of the European countries and the new approach being taken by the United States appear to be a much more appropriate manner of limiting the benefits of our treaties. The arrangements that may be made between the Netherlands Antilles and the United States have to be considered the result of a unique situation and not used as a guide to general U.S. policy in this area.

4. See Appendix. Also see Boidman and Klein, *The Impact of the 1983 Protocol on the 1980 Canada–U.S. Income Tax Convention,* 83-9 Tax Management Int'l J. 11, 14 (September 1983).

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APPENDIX

Selected "Limitation of Benefit" Treaty Provisions

1. U.S.–Luxembourg
2. U.S. 1977 Model
3. U.S. 1981 Draft Model
4. Proposed U.S.–Canada (1980)
5. U.S.–Cyprus
6. U.S.–U.K.
7. Proposed U.S.–British Virgin Islands
8. U.S.–Jamaica
9. U.S. Treasury Discussion Draft (Dec. 1981)
10. Proposed U.S.–Argentina
11. Proposed U.S.–Canada (as amended by protocol)
12. U.K.–Netherlands
13. U.K.–Switzerland

1. U.S.–Luxembourg Treaty – Article XV

The present Convention shall not apply to the income of any holding company entitled to any special tax benefit under Luxembourg Law of July 31, 1929, and Decree Law of December 27, 1973, or under any similar law subsequently enacted, or to any income derived from such companies by any shareholder thereof. In the event that substantially similar benefits are granted to other corporations under any law enacted by Luxembourg after the date of signature of the present Convention, the provisions of the present Convention shall not apply to the income of any such corporation or to any income derived from such corporation by any shareholder thereof. The expression "substantially similar benefits" shall be deemed not to include tax reduction or exemption granted to any corporation in respect of dividends derived from another corporation, 25% or more of the stock of which is owned by the recipient corporation.

2. U.S. 1977 Model Treaty – Article 16

Investment or holding companies

If 25% or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, notwithstanding the provisions of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties. For the purposes of this Article, the source of dividends, interest or royalties shall be determined in accordance with paragraph 3(a), (b), or (c) of Article 23 (Relief from Double Taxation).

3. U.S. 1981 Draft Model Treaty – Article 16

Limitation on benefits

1. A person (other than an individual) which is resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless

a) more than 75% of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and

b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

For the purposes of subparagraph a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.

4. Proposed U.S.–Canada Treaty – Article XXIX

6. If 25% or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed in that State on that company with respect to dividends (other than dividends referred to in paragraph 2(a) of Article X (Dividends)), interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, notwithstanding the provisions of Articles X (Dividends), XI (Interest) or XII (Royalties), that other State may tax such dividends, interest or royalties as if there were no convention between the United States and Canada with respect to taxes on income and on capital.

5. Proposed U.S.–Cyprus Treaty – Article 26

Investment or holding companies

A corporation of a Contracting State deriving dividends, interest, or royalties from sources within the other Contracting State shall not be entitled to the benefits of Articles 12 (Dividends), 13 (Interest) or 14 (Royalties) if:

(a) By reason of special measures the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest or royalties, is substantially less than the tax generally imposed by such Contracting State on corporate profits; or

(b) Twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned directly or indirectly by one or more persons who are not individual residents of the first-mentioned Contracting State (or, in the case of a Cypriot corporation, who are citizens of the United States). For purposes of this paragraph, a corporation that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by residents of that Contracting State.

6. U.S.–U.K. Treaty – Article 16

Investment or holding companies

(1) The provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention shall not apply to a corporation which is a resident of one of the Contracting States and which derives dividends, interest, or royalties arising within the other Contracting State if:

(a) (i) the tax imposed on the corporation by the first-mentioned Contracting State in respect of such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; or

(ii) the corporation is a resident of the United States and receives more than 80% of its gross income from sources outside the United States as determined by and for the period prescribed in sections 861(a)(1) (B) and (a)(2)(A) of the *Internal Revenue Code* of 1954, as they may be amended from time to time in minor respects so as not to affect their general principles; and

(b) 25% or more of the capital of such corporation is owned directly or indirectly by one or more persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.

(2) Nothing in this Article shall however prevent a claim under the provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) by a United States corporation where more than 75% of the capital of that corporation is directly or indirectly owned:

(a) by a United States corporation which receives 20% or more of its gross income from sources within the United States as determined by and for the period described in Subparagraph (1)(a)(ii) of this Article; or

(b) by a corporation (other than a United States corporation) which by reference to the provisions of section 283 of the *United Kingdom Income and Corporation Taxes Act 1970* (as it may be amended from time to time without changing the general principle thereof) would not fall to be treated as a close company; or

(c) by a corporation which is a resident of the United Kingdom and in which more than 50% of the voting power is controlled, directly or indirectly, by individuals who are residents of the United Kingdom.

7. Proposed U.S.–British Virgin Islands Treaty – Article 13

Investment or holding companies

A corporation which is a resident of a Covered Jurisdiction and which receives dividends, interest or royalties arising within the other Covered Jurisdiction may be taxed in that other Jurisdiction without regard to Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) if:

(a) by reason of special measures the tax imposed by the first-mentioned Covered Jurisdiction on such corporation with respect to such dividends, interest or royalties is less than the tax imposed by the first-mentioned Covered Jurisdiction on corporate profits arising in the first-mentioned Covered Jurisdiction; and

(b) twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined to be owned, directly or indirectly, by one or more individuals who are not residents of the first-mentioned Covered Jurisdiction.

8. U.S.–Jamaica Treaty

Ministry of Finance and Planning
Jamaica 17 July, 1981.

His Excellency Loren Lawrence,
Ambassador of the United States of America

Dear Excellency:

I have the honour to acknowledge receipt of your Note of the 17th of July, 1981 which reads as follows:

"I have the honour of commenting on the Protocol signed today amending the Convention between the Governments of the United States of America and Jamaica for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income, signed on the 21st day of May, 1980 ('The Convention'). The following understandings with respect to the Protocol were reached between the two Governments.

1. During the discussions of Article III of the Protocol, the Jamaican delegation expressed concern about possible implications of new Article 17 (Limitations of Benefits) contained in Article III with respect to investments that might be made in Jamaica by residents of third countries. The United States delegation assured Jamaica that the purpose of new Article 17 is to deny benefits under the Convention where residents of third countries use the Convention with a principal purpose of obtaining U.S. or Jamaican tax benefits that such persons would not otherwise be entitled to, not to impede investments in Jamaica by residents of third countries.

In order to assure that the objectives of new Article 17 are met, the delegations of the United States and Jamaica agreed that the requirements of paragraph 2 of Article 17 are satisfied and benefits are not denied under Article 17 in particular circumstances. The particular circumstances are where a company resident in Jamaica and owned by individual residents of third countries derives income with respect to which the company claims U.S. tax benefits under the Convention, the company does not use such income in the manner described in paragraph 1(b) of Article 17 and:

(i) the company is engaged in business operations in Jamaica and the income with respect to which the company claims U.S. tax benefits is incidental to or derived in connection with the business operations in Jamaica; or

(ii) the individuals owning the company are residents of countries that have income tax conventions in force with the United States and, pursuant to such conventions, the individuals would have been entitled to U.S. tax benefits the same as, or substantially similar to, the U.S. tax benefits claimed by the company under this Convention, had the individuals earned the income directly.

This agreement between the delegations is reflected in paragraph 3 of new Article 17. Paragraph 3 is not intended to suggest that the requirements of paragraph 2 cannot be met in other circumstances, nor to limit the factors that may be taken into account in determining whether 'the acquisition, ownership or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under this Convention,' as provided in paragraph 2.

2. During discussions involving the protocol, the delegations of the United States and Jamaica noted the past and present co-operation between the United States and Jamaica on legal assistance in criminal matters, including fiscal crimes, and the willingness of the United States and Jamaica to enter into negotiations designed to enhance and formalize that co-operation through modern treaties on extradition and mutual legal assistance on criminal matters."

Accept, Excellency, the renewed assurance of my highest consideration.

Prime Minister &
Minister of Finance & Planning

9. U.S. Treasury Discussion Draft of December 23, 1981 – Article 16

Investment or holding companies

1. A corporation which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State with respect to an item of income, gains or profits unless the corporation establishes that:

(a) its stock of any class is listed on an approved stock exchange in a Contracting State, or that it is wholly owned, directly or through one or more corporations each of which is a resident of a Contracting State, by a corporation the stock of which of any class is so listed; or
(b) it is not controlled by a person or persons who are not residents of a Contracting State, other than citizens of the United States; or
(c) it was not a principal purpose of the corporation or of the conduct of its business or of the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived to obtain any of such benefits.

2. For the purposes of this Article:

(a) an approved stock exchange in . . . . . . means . . . . . :
(b) an approved stock exchange in the United States means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the *Securities Exchange Act* of 1934;
(c) a person or persons shall be treated as having control of a corporation if under the income tax laws of the Contracting State in which the income arises the person or persons could be treated as having direct or indirect control of the corporation for any purpose;
(d) notwithstanding subparagraph (c) of this paragraph, a corporation is presumed to meet the requirements of subparagraph (b) of paragraph 1 of this Article if the corporation establishes that individuals who are:
 (i) citizens of the United States; or
 (ii) residents of a Contracting State; or
 (iii) residents of States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention;

 own directly more than 75% of the total combined voting power of all classes of the corporation's stock entitled to vote and more than 75% of the number of shares of each other class of the corporation's stock;
(e) a corporation is presumed to meet the requirements of subparagraph (c) of paragraph 1 of this Article, in particular, where:
 (i) the reduction in tax claimed is not greater than the tax actually imposed by the Contracting State of which the corporation is resident;
 (ii) the corporation is engaged in business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is incidental to or derived in connection with such business.

10. Proposed Senate Reservation to Proposed Income Tax Treaty between the United States and Argentina

Reservation that, a person (other than an individual) which is a resident of a Contracting State and which derives income from sources within the other Contracting State shall be entitled to the benefits under this Convention accorded by that other Contracting State if: 25% or more of the beneficial interest in such person is owned, directly or indirectly, by individuals who are not residents of the first-mentioned Contracting State. For purposes of this paragraph, a corporation that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by residents of that Contracting State. This paragraph shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

11. Proposed U.S.–Canada Treaty as amended by 1983 protocol (Article XXIX)

6. Notwithstanding any other provision of the Convention,

(a) Where profit, income or gains derived by a trust are to be treated for the purpose of the Convention as income of a resident of the Contracting State, and a principal purpose for the establishment, acquisition or maintenance of the trust was to obtain a benefit under the Convention or the 1942 Convention for persons who are not residents of the State, Articles VI (Income from Real Property) through XXIV (Elimination of Double Taxation) shall not apply in relation to the profits, income or gains of the trust; and
(b) Articles VI (Income from Real Property) through XXIV (Elimination of Double Taxation) shall not apply to non-resident-owned investment corporations as defined under section 133 of the Income Tax Act of Canada, or under any similar provisions enacted by Canada after the date of signature of the Protocol."

12. U.K.–Netherlands Treaty – Extract from Article 10, Paragraph 3(d)

(i) Notwithstanding the provisions of subparagraphs (b) and (c) of this paragraph, no tax credit shall be payable where the beneficial owner of the dividends is a company, other than a company whose shares are officially quoted on a Netherlands stock exchange, provided that the conditions for admission to such quotation, and in particular those governing the minimum value of the shares to be admitted, the transferability and the dispersion of the shares, are in conformity with the conditions set out in schedule A to the Directive of the Council of the European Communities dated 5 March 1979 No. 79/279/EEC, unless the company shows that it is not controlled by a person or two or more associated or connected persons together, who or any of whom would not have been entitled to a tax credit if he had been the beneficial owner of the dividends.
(ii) For the purposes of this subparagraph a person or two or more associated or connected persons together shall be treated as having control of a company if under the laws of the United Kingdom relating to the taxes covered by this Convention he or they could be treated as having control of it for any purpose, and persons shall be treated as associated or connected if under those laws they could be so treated for any purpose. However, where an individual is treated as having control of a company by reason only of the fact that he holds ordinary shares in the company carrying full voting and dividend rights and that individual holds not more than 10% of the total number of such

shares in the company, the shares held by him shall be left out of account in determining whether the company is controlled by a person or two or more associated or connected persons together, who or any of whom would not have been entitled to a tax credit if he had been the beneficial owner of the dividends payable to the company, provided that not more than 25% of the total of such shares in the company may be left out of account.

13. U.K.–Switzerland Treaty – Article 1 of 1981 Protocol amending Article 10 of the 1977 Treaty

Paragraph 3

(a) ....

(b) A resident of Switzerland who receives a dividend from a company which is a resident of the United Kingdom shall, subject to the provisions of subparagraphs (c) and (d) of this paragraph and provided he is the beneficial owner of the dividend, be entitled to the tax credit in respect thereof to which an individual resident in the United Kingdom would have been entitled had he received that dividend, and to the payment of any excess of that tax credit over his liability to United Kingdom tax.

(c) The provisions of subparagraph (b) of this paragraph shall not apply where the beneficial owner of the dividend is a company which either alone or together with one or more associated companies controls directly or indirectly at least 10% of the voting power in the company paying the dividend. In these circumstances a company which is a resident of Switzerland and receives a dividend from a company which is a resident of the United Kingdom shall, provided it is the beneficial owner of the dividend and subject to the provisions of subparagraph (d) of this paragraph, be entitled to a tax credit equal to one half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received that dividend, and to payment of any excess of that tax credit over its liability to United Kingdom tax. For the purpose of this subparagraph two companies shall be deemed to be associated if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by a third company; and a company shall be deemed to be controlled by another company if the latter controls more than 50% of the voting power in the first-mentioned company.

(d) (i) The provisions of neither subparagraph (b) nor subparagraph (c) of this paragraph shall apply unless the recipient of a dividend shows (if required to do so by the competent authority of the United Kingdom on receipt of a claim by the recipient to have the tax credit set against United Kingdom income tax chargeable on him or to have the excess of the credit over that income tax paid to him) that the shareholding in respect of which the dividend was paid was acquired by the recipient for bona fide commercial reasons or in the ordinary course of making or managing investments and it was not the main object nor one of the main objects of that acquisition to obtain entitlement to the tax credit referred to in subparagraph (b) or subparagraph (c), as the case may be.

(ii) Switzerland may, on or before 30 June in any calendar year, give the United Kingdom, through diplomatic channels, notice of termination of this subparagraph and, in such event, it shall cease to have effect in relation to dividends paid on or after 6 April in the calendar year next following that in which notice is given."

CONFERENCE DIARY

FEBRUARY 1984

British Branch of I.F.A.: International and U.K. mergers and demergers (Tax workshop). London (United Kingdom), 7 February (English).

Business Perspectives: Singapore 1984 (8th Biennial Wheatcroft International Tax Conference) (including: unitary taxes; the tax problems of investing in developed countries; tax havens; treaty interpretation; export incentives through tax reliefs). Singapore (Republic of Singapore), 13-15 February (English).

MARCH 1984

Management Centre Europe: Franchising (including: franchising abroad: money and taxation). London (United Kingdom), 7-9 March (English).

International Tax Planning Association: Guernsey Seminar. St. Peter Port (Guernsey) (Channel Islands), 8 and 9 March (English).

Management Centre Europe: Leasing (including: taxation and leasing; taxation and leasing-cross-border considerations). Brussels (Belgium), 12-15 March (English).

Dr. Peter Deubner Verlag GmbH: Tax beneficial investment. (Special seminar). Munich, 14 March; Frankfurt, 15 March; Cologne, 16 March (Federal Republic of Germany) (English).

Seminar Services S.A.: How to set-up and operate holding and finance companies (Netherlands, Luxembourg, Netherlands Antilles, Channel Islands, Switzerland) (including: tax treaties and tax planning). Amsterdam (Netherlands), March 13 and 14 (English).

APRIL 1984

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: Taxation of enterprises (Seminar). St. Gallen (Switzerland), 4-6 April (German).

Management Centre Europe: International Business Tax Conference (including: tax planning, including transfer pricing). Vienna (Austria), 25-27 April (English).

MAY 1984

International Tax Planning Association: 10th Annual Conference. Munich (Federal Republic of Germany), 16-18 May (English).

SEPTEMBER 1984

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina). 16-21 September (English, French, German, Spanish).

International Tax Planning Association: Monte Carlo Workshop. Monte Carlo (France), 13 and 14 September (English).

NOVEMBER 1984

International Tax Planning Association: Hong Kong Seminar. Hong Kong, 26 and 27 November (English).

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Business Perspectives: Suite 804, 1735 Eye Street, N.W., Washington, D.C. 20006 (U.S.A.).

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

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

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Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41 (Federal Republic of Germany).

Seminar Services S.A.: Chemin Ste-Agnès, 8 CH-1700 Fribourg (Switzerland).

Share Purchases Treated as Asset Acquisitions in the U.S.A. – New Section 338 –

By Marianne Burge

This article is based on a talk given on 6 October 1983 under the heading "Recent U.S. developments" at the Joint Seminar of the United Kingdom and United States branches of IFA in London.

One of the most significant changes introduced in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was Sec. 338, which applies to cash acquisitions of U.S. corporations made after 31 August 1982. This article outlines the new provisions and discusses some of the advantages, disadvantages and uncertainties which face both U.S. and foreign investors contemplating an acquisition of a U.S. corporation.

TEFRA repealed the now familiar Sec. 334(b)(2), under which a purchase of shares followed by a liquidation of the acquired company was treated as a purchase of the underlying assets. The purchase of shares, as opposed to assets, is generally more convenient from a business standpoint, and, under Sec. 334(b)(2), the tax consequences were broadly similar, except that the incidence of the recapture taxes was transferred from the seller to the buyer. The buyer in turn often had tax losses, due to interest expense and depreciation of the acquired assets, against which to offset the recapture taxes.

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Speaker and Writer – *Speeches and articles on topics of international taxation including the following:*

Published Works

Co-author, Accounting for the Multinational Corporation, Financial Executives Institute and Dow Jones Irwin.

The New U.S.-U.K. Income Tax Treaty, Income Tax Treaties, PLI 1978.

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PREVIOUS LAW

Under previous tax law there were several techniques for making acquisitions, some of which are still available. This article discusses cash acquisitions only and does not consider exchanges of shares for shares or reorganizations, under which there is no step-up of asset values.

A. Sec. 334(b)(2) permitted a purchasing corporation which acquired the shares of a target corporation to liquidate the target and increase or "step up" the tax basis of the assets to the purchase price of the shares and the assumed liabilities. The recapture taxes were imposed on the liquidating company and were thus paid by the buyer. Recapture taxes generally result from the disposal of depreciable assets and include recapture of depreciation and investment tax credit. If the acquired corporation also owns directly the shares of a Domestic International Sales Corporation (DISC) or a foreign subsidiary, there could also be a triggering of previously untaxed income from those subsidiaries. The target company would normally be included in the buyer's consolidated tax return and thus any consolidated losses would be available to offset these recapture taxes, with the exception of investment credit.

B. Sec. 346 permitted the partial liquidation of the target corporation and allowed the step-up of the liquidated assets without recapture of the investment credit and a deferral of depreciation recapture. This was a very favorable alternative in the right circumstances.

C. In the case of an actual purchase of assets, the sale gives the seller capital gains in the same manner as the sale of shares. However, the recaptures are imposed on the seller rather than the buyer. The buyer has a step-up in the assets.

D. Sec. 337 allows a corporation to sell its assets tax free, provided that the corporation is subsequently liquidated. This shifts the capital gains tax on the sale of assets by the corporation to its shareholders. However, the selling corporation remains liable for tax on the recaptures. As in C, the buyer simply buys assets and gets a step-up in the basis.

THE NEW LAW

TEFRA made the following changes to the above 4 techniques. Sec. 334(b)(2) and 346 were repealed. The purchase of assets and the use of Sec. 337 remain as alternatives to share acquisitions. New Sec. 338 broadly replaces Sec. 334(b)(2), but shifts the incidence of the recapture tax in general to the target corporation itself. No actual liquidation is required. The stated aim of the new section is to treat share purchases in the same way as asset purchases and to limit perceived abuses under previous law.

Under Sec. 338, if a purchasing corporation (PC) meets the requirements of the section, the target is treated as if it had sold its assets on the acquisition date in a Sec. 337 transaction, and as if it were a new corporation which had purchased all the assets on the day after the acquisition.

The requirements for Sec. 338 are in many respects similar to those of Sec. 334(b)(2). There must be a qualified stock (share) purchase. The PC must acquire at least 80% of all voting stock and 80% of all non-voting stock, except for non-participating preferred stock, in order to meet the qualified stock purchase requirement.

There must also be an actual or in some cases a deemed or notional election. The PC must make an election for Sec. 338 treatment no later than 75 days after the acquisition date. As a transitional measure, taxpayers are permitted to delay elections until proposed regulations are issued. None have as yet been issued. If an election is made, it will also apply to other stock purchases made by the buyer from the same target or its affiliates over a "consistency period", which could be from 2 to 3 years. If the PC acquires assets from the target, it will be treated as having made a deemed or notional Sec. 338 election with respect to any stock purchases in the consistency period. The consistency period starts 1 year before the beginning of the (up to) 12 month acquisition, and ends 1 year after the final acquisition date. The purpose of the period is to prevent taxpayers from splitting their purchases from the same group into asset and stock purchases, with a view to obtaining step-up benefits on some assets and avoiding recaptures on others.

TAX TREATMENT

If these requirements are met, the target corporation is treated as if it had sold its assets in a Sec. 337 transaction. The seller of the target shares gets capital gains treatment on the sale of the shares.

The target does not recognize gain on deemed or notional sale of its assets. However, the target is subject to corporate income tax on income subject to recapture taxes, including: recapture of depreciation, investment tax credit and possibly such other items as recapture of LIFO reserves, recapture of tax benefits, DISC income and foreign subsidiary earnings. The target must file a one-day income tax return to include the recapture items and for this one-day return the target cannot be included in the PC's consolidated tax return. Thus, the recapture taxes can no longer, as under previous law, be sheltered by the tax losses of the PC. This therefore becomes an important consideration in deciding whether or not the step-up in asset basis is an overall benefit, since the recapture taxes are an immediate cost, whereas the benefits of the step-up arise in the future and are sometimes uncertain as regards the final amount allowed by the Internal Revenue Service.

If the target was previously a member of a consolidated group, an election may be available for the target to be included in the seller's consolidated tax return for the one-day recapture return. Such election will be available under regulations specifying how and under what conditions it applies. At present there are no regulations and as the law reads at present, no election can be made before the regulations are promulgated. The purpose of including the one-day return in the seller's return is to put the parties into the same position as if they had bought and sold assets.

If the election is made by the PC, it applies to all U.S. subsidiaries of the target. It is not clear how the election applies to DISCs and foreign subsidiaries. It is suggested by some that if the DISC and foreign subsidiary is held directly by the target, the recaptures of DISC income and foreign subsidiary earnings would apply, but that if these companies are held by a U.S. subsidiary of the target, the election would not apply to them. This analysis would be consistent with previous treatment under Sec. 334(b)(2).

PURCHASE PRICE

The "new" target is, under this scheme of things, treated as having purchased the "old" target's assets. The purchase price for the assets is the price paid for the shares plus the liabilities assumed. The purchase price is allocable to the assets purchased as under previous law and practice, but the statute provides for regulations to be issued on this subject.

If the seller of the target wants to retain some of the assets not wanted by the PC, there is provision for a non-taxable redemption of shares in exchange for assets of the target to its existing shareholders.

If the PC acquires less than 100% of the target's shares, the target is treated as having purchased 100% of the assets. The purchase price is grossed up to 100%. Thus, for example, if the PC acquires 90% of the target, the purchase price of the assets is treated as 100/90 of the purchase price paid and the target pays capital gains tax on a deemed or notional sale of the 10% interest.

ADVANTAGES AND DISADVANTAGES

There are a number of advantages under Sec. 338 over previous law. No actual liquidation is required, which might be helpful in some situations, for example, in the case of U.K. groups which want to use a target's pre-existing foreign taxes as credits in the U.K. However, liquidation is permitted, without any detriment as yet apparent, which may be preferred by Canadian-based purchasers.

Since the target is treated as a new corporation, a "new" target can make new tax accounting elections and can claim accelerated depreciation and amortization of its acquired assets.

Another apparent advantage is that there is no longer a requirement that all purchases of a target's stock must actually be made by the purchasing corporation itself. For example, it appears that stock acquired by a foreign parent could subsequently be transferred to a U.S. purchasing subsidiary and would count as a qualified purchase. This was not permitted for the purpose of counting the 80% stock purchase requirement under Sec. 334(b)(2). This would permit a foreign buyer to accumulate shares in a foreign corporation until such time as he was certain that he would make an 80% acquisition. If he decided to hold the U.S. shares as a portfolio investment outside the U.S., U.S. capital gains tax could generally be avoided.

Clearly, the most significant disadvantage of the new provisions is that the recapture taxes can no longer be sheltered by the purchasing corporation's other losses. Furthermore, there is considerable uncertainty as to how, when and under what circumstances a target's one-day return can be included in the seller's consolidated tax return, and in view of the fact that this involves two negotiating parties, this uncertainty makes the inclusion an impractical alternative until regulations are issued.

Uncertainties are in fact another major difficulty with the new provisions. They stem from the structure of the new section, which treats the transaction as a Sec. 337 transaction, while at the same time seeking to replace the concepts of Sec. 334(b)(2). These two sections have behind them many decades of practice and case law. In the international area, there are some fundamental questions as to how foreign subsidiaries and DISCs fit into the system. It is unclear whether their earnings are recaptured or not and whether the election can be made separately for them or not. These matters will eventually be clarified by regulations, which should start appearing in the coming year.

In spite of these uncertainties, acquisitions continue to be made and the tax consequences on the major items, namely, the step-up in the basis of acquired assets, continue to be ascertainable under existing concepts.

AIJA ESTABLISHES NEW INTERNATIONAL TAX GROUP

The Association Internationale des Jeunes Avocats – Young Lawyers International Association (AIJA) – is a non-political organization dedicated to furthering the interests of young lawyers in particular and the entire legal profession and to encouraging co-operation among lawyers. Founded at Toulouse in 1962 and established under Luxembourg law, the Association has members in 47 countries. All practicing lawyers under the age of 45 are eligible to become members of AIJA, whose official languages are English and French.

The objects of the Association are to study advanced problems of law and questions facing young lawyers, to help in the formation of groups of young lawyers in countries where they do not exist and to intervene when the rights of lawyers to practice freely or the right to a fair trial is threatened.

AIJA works on a permanent basis in various fields of law of interest to young lawyers through its Permanent Commissions and established such a Commission for the Study of Taxation at its Executive Committee Meeting in London in May 1983. The objects of the Taxation Commission are the study and advancement of international and comparative fiscal law.

The AIJA Taxation Commission endeavors to achieve its aim by scientific research, publications and the holding of seminars and conferences and will select a major theme for examination and analysis each year. The first subject in this regard is "Tax Treatment of Non-Profit Organizations".

The AIJA Taxation Commission does not intend to simply duplicate the work done by other international tax organizations but proposes to seek out areas of study which are often neglected by other organizations, as well as areas of particular interest to young lawyers. Joint projects will be undertaken with other AIJA Permanent Commissions such as the Commission on Computers and the Law, The International Business Law Commission, the Commission on Family Law and on Employment Law.

The AIJA Taxation Commission welcomes young lawyers with a specific interest in international and comparative taxation to become members of the Commission. Enquiries should be directed as follows:

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Current Tax Law Problems for Corporations

By J. Hoogendoorn

Mr. J. Hoogendoorn is a tax attorney, cooperating with Moret Gudde Brinkman Tax Advisers in Rotterdam (the Netherlands).
This article is based on a paper in the German language entitled: "Aktuelle Probleme der Besteuerung von Kapitalgesellschaften in den Niederlanden", presented at the joint meeting of the Dutch and Swiss branches of the International Fiscal Association held on 28 April 1983 in Lucerne, Switzerland.

At this moment there are a host of tax problems which would merit discussion, but considering the time limitations imposed on me I have selected two subjects which I consider to be of prime importance: (i) the scarcity of equity capital and (ii) the residence of corporations. I appreciate, however, that this selection is necessarily subjective.

The lack of sufficient corporate equity capital is currently a very acute problem, which is, admittedly, basically a financial one, but its tax effects are particularly important in times of recession. The second issue, i.e. corporate residence is typically a tax law problem of increasing topicality.

I. THE ACTUAL POSITION OF CORPORATE EQUITY CAPITAL

During the last decades the debt/equity ratio of corporations has increasingly become less favorable in the Netherlands. Where about 15 years ago this ratio was still 60 : 40, it is currently approximately 80 : 20! Particularly, medium-sized corporations and not the big multinationals are adversely affected by this lack of equity. One may, of course, wonder what the reasons for this painful deterioration of the situation have been. The main reason is the lack of sufficient profitability. There have been a number of other reasons but two of them which have had a particularly large impact in this respect should be more closely examined:

(i) inflation, and
(ii) the so-called economic double taxation of corporate profits.

Inflation

The official index figures for 1970 (103.7) and 1979 (199.3) show that the rate of inflation in the Netherlands compared to inflation in other countries has been very modest during the period 1970-79. Nevertheless, the real value (purchase power) of the Dutch guilder in 1979 was only 50% of its real value in 1970! Even before the first oil shock at the end of 1973 it was obvious that the Dutch economy was suffering from "stagflation", i.e. limited economic growth connected with a decrease in the real value of the currency. However, due to inflation the need for capital supply was still increasing in spite of the limited economic growth. At that time it seemed a quite acceptable solution to cover the need for new capital through debt financing. The inflation would cause losses on monetary assets on the one hand and gains in monetary liabilities on the other hand resulting in some sort of compensation of losses and gains.

Economic double taxation of corporate profits

The term "economic double taxation" of corporate profits does not denote that distributed profits are subject to corporate income tax at the corporate level and to individual income tax at the shareholder level, but rather that the *full* rates of corporate income tax and individual income tax are imposed on such corporate distributions. It can generally be stated that equity-financing is expensive. If a corporate income tax rate of 50% is assumed,[1], a corporation requires a profit before taxes of 20 to cover a dividend distribution of 10.

In the past, it has been assumed that the corporate income tax burden – at any rate the corporate income tax burden on dividend distributions – would eventually be shifted on to the consumers through price increases. Whatever might have been the case, the present squeeze on the profit margins has made the feasibility of such a shift rather questionable. An important issue is whether competitors bear the same burden of such tax "costs" or perhaps less, and particularly competitors in other EEC countries. These questions are of prime importance to an export-oriented country like the Netherlands.

The lack of equity capital and the propensity to use debt financing have contributed to the vulnerable financial position of many corporations in the Netherlands and it can be stated this situation is also due to Dutch income tax legislation and to the Dutch Government not having altered this legislation in time.

Although rather late, the Dutch Government is now finally responding to the serious and vulnerable position of Dutch corporations and there is currently a series of measures to improve the situation. Former Vice-Minister of Finance, Mr. A. Nooteboom, took the initiative in 1978 to introduce provisions to offset to a certain extent the effects of inflation. The most important of these measures permits enterprises to take special deductions from their taxable income. The first one is a deduction of 4% of the value of the enterprise's inventory and the second one is a deduction equal to 4% of the equity capital used

1. During 1970-79 the standard rate of Dutch corporate income tax was 48%.

for the operation of the enterprise within the Netherlands.[2]

The Dutch Government has now also become conscious of the fact that improvement of the equity situation of enterprises is urgently needed in order to restore the basis for economic recovery and reduction of unemployment. Therefore, one of its primary targets has become combatting the lack of equity capital.

In this respect, it has been recognized by the Government that in addition to inflation there are also other factors which cause such a lack of equity capital, e.g. "economic double taxation" of corporate profits.

The question may be raised which role the "equity deduction" may play in reaching a definitive solution of the problem of "economic double taxation" of corporations in the Netherlands. In this respect one should bear in mind that most Duch enterprises also have to operate beyond the frontiers of their country. The shareholders and the holders of other financial interests in Dutch corporations are very often residents of other countries, both within and outside the Common Market. On the other hand, most Dutch investors – corporations and individuals – also hold foreign securities.

Most European countries – at least the members of the EEC – have introduced some form of "imputation system" in their tax laws to stimulate investment in equity capital. Under this system, shareholders are entitled to credit the corporate income tax – or part of it – imposed on the distributed corporate income against the income tax due on their dividend receipts. Normally the benefit of this tax credit is limited to *resident* shareholders receiving a dividend from a *resident* corporation, although under tax treaties the benefit may be extended to shareholders resident in such treaty country.

There are a number of reasons which make the introduction of an imputation system less attractive for the Netherlands. In the first place, Dutch corporations are to a large extent owned by non-resident shareholders in numerous countries. In order to give these shareholders the benefit of the tax credit a large number of tax treaties must be (re)negotiated. Secondly, income derived by Dutch corporations through foreign permanent establishments or foreign subsidiaries is generally exempt from Dutch corporate income tax. It is my personal opinion that the Dutch Government will be reluctant to grant shareholders a credit for Dutch corporate income tax which is not imposed with respect to the distributed dividend. A possible solution could be the introduction of an equalization tax like the French "précompte". However, this tax should then be refunded to those non-resident shareholders who are *not* entitled to a tax credit. This would result in a great deal of paperwork. That kind of problem should explain the reservations of the Dutch Government in this matter.

The crucial issue in my opinion is whether the introduction of an "imputation system" would lead to the result that the use of equity capital would become less burdensome – i.e. "cheaper" – to the corporations concerned. However, such a result of the "imputation system" rests in its turn on the following assumptions:

- It is assumed that under the "imputation system" the corporation distributes a lower amount of dividend since the shareholder would be compensated by the amount of tax credit attributed to him.
- It is further assumed that an extensive tax treaty network exists under which, on the basis of reciprocity, a tax credit would be available to shareholders not resident in the country. The imputation system would thus be applied on a worldwide scale or at least by the OECD member countries.

However, the assumption that corporations will be able to reduce their dividend distribution will not hold true where important shareholdings are in the possession of shareholders *not* entitled to the tax credit under the "imputation system". These corporations will be forced to distribute a dividend which their shareholders consider a fair remuneration for their capital contribution and these shareholders will not be prepared to accept a reduction of dividend because *another* group of shareholders is receiving a tax credit. A possible solution would be to differentiate between these groups of shareholders, i.e. to distribute a lower dividend only to those shareholders who are entitled to the tax credit. However, under current Dutch corporate law this would be illegal and this possibility must, therefore, be ruled out under the present circumstances. In those cases the use of equity would not become "cheaper".

A "distributed dividend deduction" would offer a *better* solution in those cases, i.e. would directly give relief to the distributing corporation without the need to differentiate between various groups of shareholders, since the distributed dividends would be treated as deductible expenses at the corporate level. This deduction may be limited to a certain percentage of the equity as shown by the balance sheet drawn up for tax purposes. However, the equity represented by substantial shareholdings (participations)[3] or the value of foreign permanent establishments should be excluded, since the income from such sources is generally exempt from Dutch corporate income tax.

Although the profitability is slightly improving, there still is an emergency situation with respect to the equity position. The current "equity deduction" might under the present emergency situation perhaps be the best solution. However, once this emergency situation were over, it could be altered into the "distributed dividend deduction" as described above, as a more definitive solution.

II. CORPORATE RESIDENCE

Dutch corporate law adheres to the "principle of incorporation" as regards the "residence" of a corporation; or, more precisely, the "statutory seat" – i.e. the seat

2. This latter deduction will hereinafter be referred to as "equity deduction". Before 1983 it was also available but at lower rates. It should be noted that the "equity deduction" may be used by both corporations and sole proprietorships and other enterprises not subject to corporate income tax. Permanent establishments of foreign corporations, like Dutch corporations and other Dutch enterprises are entitled to the "equity deduction". No distinction is made whether the shareholders are residents of the Netherlands or are resident abroad, whether in a tax treaty country or in a non-tax treaty country.
3. A participation generally exists if, among other things, a corporation owns at least 5% of the share capital of another corporation, whether resident in the Netherlands or abroad.

under the corporation's articles of association – must be in the Netherlands if the corporation is incorporated under Dutch law. This applies to a "naamloze vennootschap" (NV) and to the "besloten vennootschap met beperkte aansprakelijkheid" (BV)[4]. Therefore, a corporation like an NV or a BV cannot renounce its Dutch nationality nor can it "emigrate" (except in times of war or under the threat of war in which case the corporation may move its seat to another part of the Kingdom of the Netherlands, i.e. the Netherlands Antilles). The legal system which is in force in the Netherlands differs, therefore, fundamentally from the legal systems in countries which apply the principle of "siège réel" (real seat).

However, in principle the corporate law provisions regarding corporate residence are not relevant for tax law purposes since Dutch corporate income tax law contains its own residence provisions.

However, if one asks how "residence" is defined in Dutch corporate income tax law it appears that it is not always easy to give a clear answer. The best definition one could produce is: the residence of a corporation is its center of effective management, i.e. the center from which the operations of the corporation are directed. This roughly equals the concept of "siège réel". If that center of effective management is in the Netherlands it is for corporate income tax purposes assumed that the corporation is a resident of the Netherlands, irrespective whether it is incorporated in the Netherlands or abroad (residence by fact).

In addition, Dutch corporate income tax law contains the provision that a corporation incorporated under Dutch corporate law is deemed to be resident in the Netherlands, regardless of the place of its center of effective management (residence by incorporation). In this manner, two quite different ways lead to the same goal, i.e. to subject both types of resident corporations to "domestic tax liability".

The concept of "domestic tax liability" denotes in principle *unlimited* tax liability, i.e. the taxation of world-wide income with the exception of certain exempt income (e.g. income from participations, which is not taxable in order to avoid to a certain extent double corporate income tax on the same profits).

Although it can generally be stated that Dutch corporate income tax contains a comprehensive set of provisions directed at the prevention of double corporate income tax, *dual* residence (i.e. in the Netherlands and abroad) is possible and this can easily result in double taxation by foreign and Dutch authorities. However, tax treaties concluded by the Netherlands patterned along the OECD Model Treaty will remove the consequences of such a dual residence because, where such a tax treaty applies, the residence of a corporation will be determined by the place of its effective management. The question could be raised whether a Dutch NV or BV incorporated in the Netherlands under Dutch law, having its place of effective management in a treaty country, will cease to be subject to domestic tax liability in the Netherlands. The answer is negative, but the income from sources attributed by the treaty to the country of residence (in this case the "residence of fact") will be "excluded" for Dutch corporate income tax purposes.[5] The term "excluded" should be distinguished from the term "exempt". However, to explain in detail the difference between these concepts would bring us outside the scope of this paper. Suffice it for purposes of this article to state that in such a case the NV or the BV will be subject to "*limited* domestic tax liability" in the Netherlands. The term "limited tax liability" denotes an exception to the general rule that "domestic tax liability" equals "unlimited liability".

The tax treaty concluded between the Netherlands and Switzerland differs from the treaties concluded on the basis of the OECD Model Treaty in that under the provisions of this treaty the residence of a corporation is determined by its "statutory seat". This means that a Dutch NV or BV having its place of effective management in Switzerland will retain its residence in the Netherlands for purposes of the treaty. Similarly, a Swiss AG or GmbH having its place of management in the Netherlands is deemed to be a resident of Switzerland for treaty purposes, provided of course that its statutory seat is in Switzerland. Although such an AG or GmbH will be a resident of the Netherlands according to Dutch national law (residence of fact), the right of the Netherlands to levy corporate income tax will be limited to the income which is attributed to the Netherlands for treaty purposes.

The question could be raised whether this situation could be used for the creation of so-called letter box corporations in Switzerland which operate in the Netherlands. In other words, would the treaty provision allow a Swiss corporation whose exclusive field of operations is in the Netherlands to avoid Dutch corporate income tax? The Supreme Court has passed its judgement on this question in its decision of 24 November 1982 (cited as BNB 83/103). The litigation concerned a Swiss AG which was wholly owned by a Dutch parent corporation and which had its place of management in the Netherlands. The Swiss AG did not carry on any business operations in Switzerland, i.e. it was a mere letter box company in the country of incorporation (i.e. it has, as the Swiss express it, a mere *Briefkastendomizil* in Switzerland). The Supreme Court held that the total profit made through the management (which is considered to be a permanent establishment situated in the Netherlands) must be considered to be income derived through a permanent establishment located in the Netherlands and therefore subject to Dutch corporate income tax. This decision, therefore, contains a warning that the Supreme Court should not be taken lightly in its efforts to combat tax evasion!

4. The Dutch NV can be compared with the German *Aktiengesellschaft* (AG) or the French *société anonyme* (SA). The Dutch BV is a limited liability company comparable to the German *Gesellschaft mit beschränkter Haftung* (GmbH) or the French *société à responsabilité limitée* (SARL).
5. In German and Swiss tax terminology: "*ausgeschieden aus der Steuerhoheit*".

IFA **news**

REVISED RESOLUTION ON SUBJECT II (VENICE CONGRESS 1983)

The Resolution on Subject II discussed during the Venice Congress 1983 has been slightly amended in that under proposal III, last sentence, the words: "and personal transactions; but these should be restricted as much as possible" have been deleted following a decision of the General Assembly in Venice.

The text of the Resolution which was initially published in 37 *Bulletin for International Fiscal Documentation* 11 (1983) at 516-517 now reads as follows:

SUBJECT II:

International problems in the field of general taxes on sales of goods and services

RESOLUTION (original version)

CONSIDERING:

1. The worldwide use of general consumption taxes on sales of goods and services, the growing volume of international trade, and the increasing contacts of traders with foreign tax jurisdictions;
2. GATT Article III "NATIONAL TREATMENT ON INTERNAL TAXATION AND REGULATION", which sets forth the principle of equal treatment of imported and domestic goods, and the importance of applying this principle to all kinds of goods and services; and
3. The widespread acceptance of the territoriality principle combined with the destination principle in the field of general consumption taxes;

NOW IFA PROPOSES:

I. That national legislation on consumption taxes should implement these principles in a manner which ensures that double taxation and distortion of competition do not occur.

II. That countries should adopt appropriate measures to avoid any consumption tax burden on exports of goods and services, which result can be achieved most easily by a VAT or a retail sales tax system. These systems also more easily achieve the elimination of hidden tax burdens on imports and sales within the territory.

III. That even in a VAT or retail sales tax system, provisions in national legislation should be eliminated which impose an implicit tax (taxe occulte) on sales of goods or services. Input tax deduction in VAT systems is a fundamental requirement and should be based on the use of goods and services for business purposes unless this input is attributable to exempted output.

IV. That, in order to avoid double taxation, international organisations should undertake the difficult but highly desirable tasks of developing:
a. harmonised concepts concerning the territorial attribution of different types of transactions (especially in the field of services), and
b. commonly accepted definitions of terms used in general consumption taxes, such as "goods", "services" and "business".
In the meantime countries should minimise differences in such concepts and definitions by bilateral actions.

V. That in the application of general consumption taxes, foreign businesses should be treated in the same way as domestic businesses, both in legislation and administratively.

PAKISTAN:

Constraints on the Arbitrary Exercise of Authority and the Income Tax Law

By A.A. Zuberi

"Nowhere has so small a substance cast so large a shadow"

This is what Gladstone said about the Prime Minister of England. I believe there would be little cause for any quarrel with Gladstone if he had said the same about an Income Tax Officer (I.T.O.). Like the British Prime Minister (in his own realm), an I.T.O. is a key (perhaps corner) stone in the income tax arch. He is central to its foundation and as such occupies a pivotal place in the income tax hierarchy. Most taxpayers (and also people in general) regard him as actually "the be all and end all" of all that pertains to income taxation. This is so because in point of fact an I.T.O. combines in himself "the judge" as well as "the giant" who has all the power under the law to create a charge on income and levy tax thereon. This makes his job all the more important and also difficult. To see that "the judge" in him keeps even pace with "the giant" or that "the giant" does not by-pass "the judge" is mainly the law drafters' responsibility, and they have very carefully devised a mechanism which pervades the Income Tax Ordinance. No doubt the Ordinance has vested enormous powers in an I.T.O.; so much so, that this aspect has assumed the shape of a widespread debate in which it is the I.T.O. who emerges as the central figure. One view mainly focusses on the so-called harshness or high-handedness attributed to an I.T.O. whereas some others highlight the scope of his discretion or authority. It will be my endeavour to rinse away some of the confusion which surrounds this issue and point out that an I.T.O.'s authority does not go unchecked by the same law which has made him so powerful.

Let us begin by admitting that taxation is a very sensitive issue. Historically speaking, it has aroused feelings of opposition and hostility amongst taxpayers which, at times, have resulted in outright rebellion. The emergence of the U.S.A. as an independent power may well be a relevant point in this regard. It was "taxes" which made Great Britain lose America or, on the contrary, made the U.S.A. gain independence. Inasmuch as one person's loss proved to be another person's gain, "taxes" may not now be blamed for having created a nuisance. In fact, the position was actually balanced through independence of the U.S.A. where taxation (especially income taxation) has featured as one of the most important public policy issues. In almost every progressive country of the world, taxes emerge as one of the most significant contributory factors to public funds, despite the obvious lack of enthusiasm with which taxpayers, in general, regard them. In brief, their presence as "the necessary evil" has been acknowledged by almost everyone. It is a fact that nobody wants to part with his earnings and that the portion of income which is claimed by taxes is bound to create some discontent, yet this discontent is not unusual nor should it be regarded as something disconcerting. The taxpayers, almost always as a fraternity, share this discontent in every country of the world, yet the proverbial taxman (despite everything that could be said to his discomfiture) has been more keen than ever, to demonstrate that it is only he who can "squeeze the lemon". Taking you through the Ordinance, I may hold that the Ordinance, as a piece of legislation, ensures that while squeezing the lemon, the taxman abides by the rules of the game or else it is the Ordinance itself which may raise its finger and give him a "run-out".

Mr. A.A. Zuberi joined the Income Tax Service in 1960 after qualifying at the country-wide competition for Central Superior Services conducted by the Pakistan Federal Public Service Commission. In 1974 he was again selected by the Public Service Commission for the post of Accountant Member of the Income Tax Appellate Tribunal for Pakistan.

After serving for 8 years as an Accountant Member, Mr. Zuberi was transferred as Commissioner of Income Tax in 1982. He is currently head of the Directorate of Training (Income Tax) where officers, recruited through competitive examination for the Income Tax Group, are imparted training. This institution also conducts refresher courses for in-service officers.

Articles by Mr. Zuberi on tax matters have appeard in leading newspapers and tax journals. Numerous judgments delivered by him as Accountant Member, both on matters of accountacy and law, are reported in tax journals and are cited as case law. He is also on the panel of Examiners of the University of the Punjab, Lahore.

The present article is based on a paper read at a Seminar organized on 6 June 1978 by the Management Association of Pakistan at Hotel Hilton, Lahore, Pakistan.

The Income Tax Ordinance, 1979 contains everything that a piece of tax legislation may (or ought to) contain and whatever it contains is much less severe than what may be cited as examples in the two countries with which we are familiar, namely, India and England.

Whereas the Income Tax Ordinance gives wide discretionary powers to the I.T.O. in as many as 45 sections, it imposes restrictions on him as well which are by no means less than the powers he enjoys under the law. This even-handedness is quite admirable.

The king-pin in the income tax system in Pakistan is the I.T.O. who is defined in sub-section (25) of Section 4 to mean "a person appointed to be an I.T.O. under Section 4, and includes an Assistant Income Tax Officer (A.I.T.O.), Special Officer and Tax Recovery Officer". He is mentioned among income tax authorities in Clause (e) to sub-section (1) of Section 3 and his position in the hierarchy is determined by sub-section (3) of Section 3. The appointment of an I.T.O. is made by the Central Board of Revenue (C.B.R.) as per authority in Section 4(1) of the Ordinance. The jurisiction of the I.T.O. is specified in sub-sections (3), (4) and (6) of Section 5 while sub-section (5) debars entitlement to call in question the jurisdiction of an I.T.O. once a person submits to it.

I.T.O. bound by instructions from the C.B.R.

The first constraint in the Ordinance on the powers of an I.T.O. is contained in Section 7 which prescribes that he may be "assisted, guided or instructed by any authority to whom he is subordinate". . . . Another effective curb on his powers is included in Section 8 which puts him under a legal obligation to "observe and follow the orders, instructions and directions of the C.B.R.". Even a cursory reading of these two provisions of law clearly brings out that the authority of the I.T.O. is not unbridled. He is bound by the statute to comply with orders, instructions and directions issued by the C.B.R. The power of issuing orders, etc. is so freely and frequently exercised by the C.B.R. that practically on every aspect of procedure (or practice), and at times on certain interpretations of law, one or the other circular exists. In fact, whenever an occasion arises out of any complaint or some controversy on any matter of taxation or whenever there is any doubt or misapprehension on any point in the rank of taxpayers, the C.B.R. promptly attempts to save the situation by issuing suitable orders, instructions and directions. There is no known instance of any such order, instruction or direction ever having been violated by any I.T.O. As for assistance, guidance, etc. (as provided by Section 7), the C.B.R. has time and again formed committees for detailed scrutiny of cases, for processing declarations, for agreed (or compromise) assessments and for writing off irrecoverable tax demand.

Valuation of investment subject to approval

If an assessee is found to have made an investment or if he happens to be the owner of valuable articles or he incurs expenditure which he is not able to explain satisfactorily, the I.T.O. has the authority to treat the unexplained amount as income. Admittedly, proof to such end should be such as an I.T.O. thinks to be "satisfactory" and it is his satisfaction which matters; but the lawmakers have very thoughtfully prescribed in the proviso to Section 13(1) that no addition for deemed income be made "unless prior approval of the Inspecting Assistant Commissioner (I.A.C.) has been obtained". Similarly, if the I.T.O. desires to enhance the value of any investment, etc. he has to obtain further approval of the I.A.C. as per sub-section (2) of Section 13 of the Ordinance. However read, these provisions are intended to serve a condition limiting the exercise of an otherwise arbitrary power.

Sub-section (2) of Section 29 vests discretion in the I.T.O. to determine "fair market value" of a capital asset if he has "reason to believe" that the transfer was effected with a view to avoiding or reducing the liability and that the sales price of such asset transferred to any person (directly or indirectly connected with the assessee) has been understated. This "fair market value" is then to be deemed consideration received by the assessee. The concept of "fair market value" is distinct but not arbitrary for the law makes it obligatory that the price shall be the same as the asset would ordinarily fetch in an open market and, where such price is not ascertainable, the approval of the I.A.C. is mandatory as per sub-section (3) of Section 29 of the Ordinance.

Restraint on unjust assessment

Where no method of accounting is employed by the assessee or the method is such that "in the opinion of the I.T.O." income, profits and gains cannot be properly deducted therefrom, or where the assessee fails to maintain books, etc. as prescribed by law, sub-section (3) of Section 32 demands that the income, profits and gains shall be computed "on such basis and in such manner as the I.T.O. thinks fit". The authority to declare that income cannot be properly deduced from the books as maintained is tied up with an enormous responsibility to determine a basis for the assessment. The I.T.O. is thus debarred from taking a leap in the dark and indulging in pure guess-work so as to produce an unjust assessment without any basis. There is no dearth of case law proclaiming that the responsibility of the I.T.O. is to compute the income as close to the true figure as is possible under the circumstances. Moreover, the decision to declare the book-version false and unreliable cannot be perverse or vindictive. It should be such as would stand the test of reasonableness and justification. The opinion of the I.T.O. does carry weight but admits of no waywardness. Therefore, it may be seen that the provision of law admits a built-in constraint which is almost binding on the I.T.O.

Need for consultation

In the matter of filing income tax returns, as per Section 55 of the Ordinance, the discretion given by sub-section (3) is restricted to 15 days only and no further extension can be granted without the approval of the I.A.C. This provision ensures uniform treatment and eliminates the chance of unnecessary favour of undue harshness towards the taxpayers. Consultation with superior officers undoubtedly ensures the existence of reasonable ground for extension of the time limit in deserving cases.

Completion of self-assessment cases well within time

The bold experiment of self-assessment has proved a big success in Pakistan. The income, as per return, is accepted so as to generate confidence and understanding between the taxpayers and tax gatherers. With this scheme goes the corresponding duty of the taxpayer to do no more than to declare the income correctly. Therefore, a small percentage of cases is picked up each year for so-called detailed scrutiny. The apprehension that an I.T.O. may not accept a return under self-assessment and may keep the assessee on tenterhooks has been taken care of by the legislation which has made it mandatory that all returns under self-assessment should be accepted by the close of the financial year next following the income year in respect of which the return is furnished under Section 55. This provision of law compels the I.T.O. to act in time and not to prolong the matter. It also curtails the authority to pick and choose cases or assessment.

Curtailment of I.T.O.'s power for provisional assessment

Provisional assessments are made with a view to adjusting the advance payment of tax so that collection is regularized. Such an assessment can be framed under Section 60 of the Ordinance even in those cases where an income tax return is not furnished for the income year. However, the I.T.O. has not been given a free hand to adopt whatever "total income" he likes. His authority is restricted to assessing provisionally the "total income" and the tax is payable only "on the basis of the assessment made for the latest preceding assessment year". Therefore, in a new case where earlier returns remain unprocessed (possibly because of declared losses, etc.), an assessing officer cannot create a demand through provisional assessment and require payment thereof without first complementing earlier assessments, computing loss (if any) and setting it off, as per law.

Time limit for summoning records/accounts, etc.

The power of the I.T.O. in Section 61 to call for accounts, documents or evidence (including accounts or documents relating to any period prior or subsequent to the income year) carries a restriction as contained in the proviso to this Section. It is specifically laid down that "the I.T.O. shall not require the production of any accounts relating to a period more than three years prior to the income year". There is thus no chance of assessment by demanding books of account of such remote past such as may have been either destroyed or discarded by the assessee. The assessees are consequently spared the hardship of having to preserve records, documents, etc. for an indefinite period fearing that the I.T.O. may press for their production while making assessment of any subsequent year.

Treatment in case of disagreement with counter opinion of authorised persons

We have seen, as per Section 7 of the Ordinance, that the I.T.O. may be assisted, guided or instructed, inter alia, by any person authorised by the C.B.R. When such a person tenders an opinion on any point concerning assessment and the I.T.O. disagrees with him, he cannot summarily brush aside the opinion. On the contrary, the law requires the I.T.O. to incorporate that opinion in the assessment order and to record reasons for not accepting it. The I.T.O., therefore, cannot help attaching due importance to the opinion of the person authorised to assist him. Inclusion of the opinion in assessment order enables the appellate authority to appraise the weight and worth of the opinion and also to see whether enough justification existed for non-acceptance by the I.T.O. This curtails the discretion of the I.T.O. to the minimum.

Best judgment assessment a restraint by itself

It needs to be stated with emphasis that an ex-parte dismissal or a disadvantageous order against the assessee is foreign to the scheme of the Income Tax Law. Although an assessment made under Section 63 may generally be treated as adverse (or harsh), it is not really so inasmuch as the Income Tax Ordinance envisages a "best judgment assessment" in the contingency of failure to furnish a declaration of income or for failure to comply with notices for appearance, etc. The assessee's responsibility to assess the "total income to the best of his judgment" still lies with the I.T.O. who is required by law to formulate assessment "to the best of his judgment". This is both an embargo and a safety mechanism, i.e. an embargo on the I.T.O. and safety mechanism for the assessee whose failure may well have occasioned by unavoidable circumstances or may have been founded on genuine reasons. The responsibility of the I.T.O. in such a situation is relatively greater as the "best judgment assessment" is not expected to be arbitrary, capricious or vindictive.

Time limit for regular and other assessments

Section 64 of the Income Tax Ordinance by its three subsections compels the I.T.O. to make all regular assessments within "two years from the end of the financial year in which the return is (belatedly) filed" and where no return of income is filed within "2 years from the end of the financial year in which notice (calling for return) is issued". This section ensures finality of proceedings in various situations and protects the taxpayers from otherwise unlimited power with reference to the time limit for assessment.

Limit on additional assessment

It may be readily seen that even in those cases where income escapes assessment or is underassessed, etc., the I.T.O. is not allowed, by law, to initiate a fishing or roving enquiry to the discomfort or inconvenience of the assessee. The law places restrictions on him by prescribing that the I.T.O. should either have in his possession definite information or he must obtain prior approval of the I.A.C. There is no dearth of case law to the effect that agony which normally accompanies the re-opening of an assessment must not result from the mere whim and caprice of the I.T.O. Again, sub-section (3A) of Section 65 binds an I.T.O. to finalize additional assessment proceedings within a period of "one year from the end of the financial year" in which notice under Section 65 is issued. This aims to debar the I.T.O. from dragging the proceedings unnecessarily which may cause bother to the assessee. Similarly, finality of assessment proceedings has been secured by placing an embargo on the I.T.O. not to initiate proceedings for additional assessment after ten years from the end of the assessment year in which "total income" was first assessable. The period of ten years from the end of the assessment year for re-opening an assessment is no doubt quite long; it may not constitute a reason for unnecessary fear amongst the taxpayers. It is so because settled cases (except in rare circumstances) are seldom re-opened and in this context the ten-year period may not alarm anyone.

Limit on completion of assessment in special cases

In order to persuade the I.T.O. to act promptly in such cases where "consequential" orders (e.g. orders as a consequence of certain directions) are to be passed, Section 66(1) prescribes time limits, depending on situations, or one or 2 years "from the end of the financial year in which the order is received by the I.T.O.". The benefit flowing from this law provision is that it is no longer to deny effect to an appeal especially in those cases where this is favourable to the taxpayers. This also facilitates the determination and the issuance of refunds which we shall presently discuss. Likewise, the I.T.O. can no more linger on a case where a Civil court in Pakistan has settled any dispute about ownership of a property. The provisions of sub-section (3) of Section 66 require him to act "within one year of the end of the financial year in which the decision of such court is brought (or otherwise comes) to his notice".

Counter-check on erroneous assessments

The arbitrary exercise of authority by the I.T.O. can be against both the assessee and the state. It requires no imagination to see that passing an order which is erroneous and prejudicial to the interest of revenue (against the state) signifies abuse of authority and betrayal of trust. Therefore, to save the state from such mischief, the Income Tax Ordinance vests overriding powers in the I.A.C. to revise (or modify) any order in such cases where he considers that the I.T.O. has passed an order which is "erroneous in so far as it is prejudicial to the interest of the revenue". Here also to eliminate the chance of hardship to the taxpayers, it has been made mandatory for the I.A.C. to give opportunity to the assessee of being heard and to cause an enquiry to be made before passing any order.

Automatic registration of firms

Section 68 of the Income Tax Ordinance creates a vested right for a firm to be taxed at reduced rates. For registration under this section, and for benefiting from the concession as prescribed by law, the rules lay down a procedure which has to be strictly followed. Instances were not infrequent where registration was refused (or not quickly settled) on flimsy grounds, thus causing undue harassment to taxpayers. The law now guarantees prompt action by the I.T.O., and in case he fails to make an order within the prescribed time, the firm gets the benefit of automatic registration by operation of law. This considerably curtails the possibility of arbitrary exercise (or non-exercise) of authority by the I.T.O.

Expenditure quantification in liquidation cases

Liquidation proceedings in respect of a private limited company can linger on indefinitely if the I.T.O. abstains from quantifying the amount sufficient to provide for any tax which is then (or is likely thereafter to become) payable by such company. Sub-section (2) of Section 76 legally binds the I.T.O. to communicate this amount to the official liquidator "within three months of the receipt of a notice from the liquidator". As liquidation cannot be finalized without first making provision for income tax due, the delay in its quantification by the I.T.O. could have been an impediment. This has been taken care of by the legislation.

Limit for power of recovery from private limited companies

It is provided by law that "every person who is (or was at any time during the income year) a director of the company and every shareholder owing not less than 10% of its paid-up share capital at any time during the income year" is jointly and severally liable for the payment of tax on a private limited company. The I.T.O. can, therefore, legally call upon any one of these persons to pay the tax due to the Government. The authority of the I.T.O. to pick and choose from amongst such persons has, however, been circumscribed by Section 77 which makes prior approval of the Commissioner of Income Tax (C.I.T.) a condition for initiation of recovery action under this section.

Stripping of powers for stay or instalments

In order to achieve collection targets, I.T.O.s, in their zeal, are more likely to deny stay of demand or facility of instalments even in genuine cases. Sub-section (2) of

Section 85 takes away the power of discretion from the I.T.O. In departure from the provisions as contained in the repealed Act of 1922, it is now the I.A.C. who is empowered to grant stay or instalments.

Constraints in respect of refunds

Section 99 of the Income Tax Ordinance deals with the procedure for refunds due to taxpayers. It specifies time for filing of applications and authorises the I.T.O. to admit applications even after expiry of the prescribed time on being satisfied "that the assessee was prevented by sufficient cause from making the application in time". However, to rule out the chance of favour to some and denial to others, such permission can only be granted after due approval from the I.A.C. Moreover, in order to avoid possibility of delay in the determination of refund, a further overriding clause has been introduced in sub-section (5) of Section 99 whereby the refund automatically becomes due by operation of law if the I.T.O. fails to act "on or before the 30th day of June of the financial year next following the date on which the application for refund is made". This right, however, is exerciseable by an assessee only if he informs the Commissioner before 31 May of the said financial year about such act of omission on the part of the I.T.O.

In order to facilitate prompt payment of refunds due (or deemed to be due) to the assessee, the Ordinance contains Section 102 of which sub-section (1) relates to additional payment for delayed refunds. In order to avoid a burden on the Exchequer in respect of such additional payments, the I.T.O. is expected to be extra careful not to delay the refunds. However, in such cases where the refund is to be withheld on genuine grounds, Section 103 empowers the I.T.O. to do so, though not without obtaining the approval by the C.I.T. who (as a second check) has to determine the period up to which the refund may be withheld.

Hedging of I.T.O.'s discretion in penal provisions

In the matter of imposition of penalties there are constraints on the powers of the I.T.O. For failure to maintain the prescribed account (Sec. 109) and for concealment of income (Sec. 111), the minimum and maximum penalty limits cannot exceed the amount as prescribed by law. Likewise, for failure to give notice of liquidation (Sec. 114) and for causing obstruction (Sec. 115), the penalty is not to exceed 10,000 Rs. in each event. All the above penalties as per Section 116 are further subject to approval by the I.A.C. who also has to extend to the assessee a reasonable opportunity of being heard. This discretion of the I.T.O. in all such matters is thus sufficiently hedged.

Curtailments of power for prosecution

In the matter of initiation of prosecution proceedings, the I.T.O. has to set in motion the proposal (under Sec. 125) for sanction of prosecution by the C.B.R.

Counter-check by appellate/superior authorities

The jurisdiction vested in the appellate and revision authorities as per Sections 129, 135, and 138 also acts as a counter-check against exercise of arbitrary power by the I.T.O. whose orders are open to scrutiny and examination by the two appellate authorities or by the revision Commissioner. The I.T.O. is, therefore, under constant scrutiny by these authorities who have the power to grant relief and to give directions as they deem fit. They have never been hesitant in openly reprimanding any questionable conduct.

Restriction on seeking information from banking companies

The Income Tax Ordinance, in Section 144, saddles the I.T.O. (and other officers) with the authority to call for information from: (i) those who pay rent, interest, commission, royalty or brokerage or annuity; or (ii) any dealer, broker or agent or any person concerning the management of any Stock or Commodity Exchange. This power also extends to securing information from banking companies, but the I.T.O. cannot issue any notice to a banking company without approval of the C.I.T. This restriction upholds the sanctity and secrecy of bank accounts while it curtails the power of the I.T.O.

Restriction on entry by the valuers

The I.T.O. can be assisted by the valuers who (as per Sec. 67) may be authorised to assess the proper value of any capital assets. Lest the valuers should be asked (by the I.T.O.s) to make indiscreet entry into any place for this purpose, sub-section (3) of Section 146 makes prior approval of the C.I.T. a condition precedent to such an action.

Ban on disclosure of information

Last (but not the least) is the ban (in Sec. 150) on disclosure by the I.T.O. of information relating to assessees as obtaining in any statements made, returns furnished, accounts or documents produced, evidence given, affidavit or deposition recorded in the course of proceeding, etc. The I.T.O., therefore, has to act very cautiously and carefully lest any false step should result in prosecution proceedings against him for disclosure of information relating to income of an assessee.

Commitment to go by rules

The anxiety of the legislature to save the taxpayers even from the remotest chance of misuse (or abuse) of power by the I.T.O. is manifest in specific instances cited above. Additionally, to remove anomalies, to mete out a uniform treatment and to keep the I.T.O.s within legal bounds, the C.B.R. has framed Income Tax Rules under sub-section (1) of Section 165 of the Ordinance. For computing income from salary under Section 16, rules 3-18 lay down the method for determining the value of:

- perquisites and allowances;
- residential accommodation or the house rent allowance;
- conveyance or conveyance allowance;
- concessional passage for travel;
- entertainment and medical allowances; and
- other benefits.

In respect of income from house property (taxable under Sec. 19) the rules pertain to deduction of unrealized rent. Similarly, for determining income from business or profession, criteria for setting admissibility limits have been specified in Rules 20 to 25 for such items as:

- head office expenditure in the case of non-residents;
- entertainment expenditure;
- particulars required to be furnished for claiming depreciation;
- treatment of royalties or fees from technical services;
- determination of income attributable to operations carried out in Pakistan by non-residents and to transactions with non-residents;
- computation of income which is partially agricultural and partially from business.

As regards income from other sources (under Sec. 30) the method of valuation of taxable perquisites, benefits, allowances (in case of part-time directors, etc.) has been laid down in Rule 26. The Rules, by prescribing the parameters, considerably reduce the power of discretion exercised by the I.T.O.

In the preceding discussion I have repeatedly used several expressions like "reason to believe"; "in the opinion of the I.T.O."; "best judgment assessment"; "satisfaction of the I.T.O." and "according to his discretion". All these terms denote some judicial concepts based on a long line of authoritative pronouncements by various superior courts. It is beyond controversy that case law carries a weight equal to the statute itself. Moreover, the Constitution and judicial decorum compel all lower courts on any piece of legislation. It would, therefore, be worthwhile to discuss the scope of the above terms in the light of leading case law.

Reason to believe

The expression suggests that the belief must be that of an honest and reasonable person based upon reasonable grounds and that the I.T.O. may act on direct or circumstantial evidence but not on a mere surmise, guess or rumor [(1982) 45-Tax-45-268 (India) HC *in re* Asoke Kumar Sen; also (1980) 45-Tax-45 (Karachi) *in re* Mohmmadi Textile Mills Ltd.].

The expression "reason to believe" does not mean purely subjective satisfaction on the part of the I.T.O. The reason may be held in good faith. It cannot be made merely a pretence. It is open to the court to examine whether the reason has rational connection with (or a relevant bearing on) the formation of the belief and that it is not extraneous to or irrelevant for the purpose [(1977) 35-Tax-149 (SC India) *in re* Lakhmi Mesal Das].

The I.T.O. may act only after he is in possession of any material to justify a reasonable and honest belief. He is, however, not entitled to embark upon a fishing and a roving enquiry of his own in the hope of collecting some material to justify his action [(1977) 34-Tax-92 (Karachi) *in re* M/S Paramount Electric Company].

In the opinion of the I.T.O.

The law gives certain latitude to the I.T.O. by employing these words. The opinion of the I.T.O. has, therefore, to be given due weight unless it is shown that he acted in an arbitrary or capricious manner. If there is material on record to justify the proper exercise of opinion by the officer, he cannot be questioned [(1980) 41-Tax-148 (Lhr HC) *in re* M/S Menga Industries Ltd.]. However, "opinion" is as misleading a concept as perhaps "feeling" is. The law presumes that the I.T.O. would not equate his opinion with his "feelings" or any subjective experiences. He would construe "opinion" in its legal context so as to exercise ambivalence and propriety in all such matters where he is required to form (and thereafter) follow any opinion.

Best judgment assessment

If the I.T.O. makes the assessment (to the best of his judgment) believing it to be fair, though it is likely that this process involves some amount of guess work, the assessment would not be assailable on that ground alone. In any case the I.T.O. is the best judge in the matter and no fault can be found with "the best judgment assessment" unless it is proved to be deliberately dishonest, vindictive or capricious [(1980) 41-Tax-51 (Karachi) *in re* M/S Imperial Paint & Varnish]. Therefore, despite his authority remaining unquestioned, what he has to guard against is capriciousness, vindictiveness and dishonesty. The constraints, being self-operative, reflect on positive curtailment of "unjudiciously exercised authority".

Satisfaction/satisfy/is satisfied

What all this implies is apparently "a subjective satisfaction of the I.T.O.". The question of satisfaction inevitably depends upon the material available with the I.T.O. and such material would also be looked into by the courts. No doubt if cogent material is available before the I.T.O., the courts would normally decline to interfere, but if the courts come to the conclusion that the words "is satisfied" are being used only as a cog to advance hardship they would always extend relief [(1980) 42-Tax-12 (Karachi) *in re* Mohammed Muslim]. It may, therefore, be inferred that "satisfaction" has the same legal connotation as is necessary for a "belief" which, in order to sustain, has to be honest, impartial and judicious.

The Ordinance at places does give some latitude to the I.T.O. by employing phrases like "the explanation offered . . . is not, in the opinion of the I.T.O. satisfactory . . .". A word or two may therefore be said about the import of these legal expressions. It needs no elaborate arguments to establish that the opinion on the basis of which "satisfaction" may have to be expressed for initiating any legal proceedings, may be accurate (or erroneous) but it must be an honest conviction based on tangible material capable of sustaining such "opinion" and not a mala fide opinion or colourable exercise of statutory power [(1974) 30-Tax-27 (Karachi)]. What is required is that there must be reasonable grounds known to the officer (and made clear to the assessee) before the power in this behalf is validly exercised. The "opinion" must be that of a prudent person, based on reasonable grounds emerging from direct or circumstantial evidence but not on mere suspicion or rumor. Similarly, the conclusion about the satisfactory nature of the explanation must emanate from a state of mind which has been induced by the existence of reasonable grounds for satisfaction (or dissatisfaction). Moreover, such opinion or satisfaction should be clearly mentioned in the order itself as this is a direct way to give out the mind of the authority who passed the order. It is all the more essential in an appealable order so as to enable the higher forum to know whether mind was consciously applied to the material brought on record. The opinion, or satisfaction, unless demonstrated in absolute terms cannot be presumed; hence it should be mentioned in unambiguous language. In the absence of reasons recorded to justify such opinion or satisfaction, the whole exercise would become tainted with illegality and may amount to non-application of mind which would render it devoid of lawful authority [(PLD-1969-SC-14 and PLD-1979-Lhr-79)].

"Opinion", therefore, may be construed as something capable of affording "satisfaction" to the one who is disposed to opine. Both, in this sense, are closely interrelated and may be strictly construed to appreciate their true legal import. If the I.T.O. is thus forced to exercise power after ascertaining the import of these trickly legal expressions, he may have no reason nor any chance to act arbitrarily.

According to the discretion

The elementary principles of justice demand that discretion should be judiciously exercised. The decision-maker should be free from malice, caprice, or arbitrariness. According to Maxwell, where something is left to be done according to the discretion of the authority on whom the power of doing it is conferred, the discretion must be exercised honestly and in the spirit of the statute, otherwise the act done would not fall within the statute. "According to his discretion", therefore, means, according to the rules of reason and justice, not private opinion; according to law and not humour; it is not to be arbitrary, vague, or fanciful, but legal and regular; to be exercised not capriciously, but on judicial grounds and for substantial reasons. And it must be exercised within the limits to which an honest man, competent to discharge his office, ought to confine himself. That is, within the limits and for the objects intended by the legislature.

It may be mentioned in the end that meaningful safeguards have been provided in the Income Tax Ordinance, 1979 and it is up to the taxpayers (by their adherence to law and by truthful declaration) to respond to the faith reposed in them. The discretionary powers of the I.T.O. have been reduced to the minimum but where there is a question of appreciation of evidence, it is not the exercise of discretion which finds free play but a judicial appraisal of objective evidence in accordance with the well established rules. What now remains with the I.T.O. (or other tax authorities) are only the entitling powers which have to be used with great care and circumspection. We all know that law seeks to nullify mischief but not many care to understand that the stringency of laws grows with their non-observance. This leads us to realize that despite seemingly wide powers, the I.T.O. is very much enslaved by restrictions emanating from executive orders, from the statute itself and from judicial pronouncements. One may wonder as to how the same law (which has decorated the I.T.O. with wide powers) may like to strip him of his authority. This may look paradoxical. But, if the child can be the father of man (to quote a poet), the law (being law) can go very much beyond it by transforming the "father" into a child" again if he conducts the business in an "unfather-like" manner.

[For Appendix, see overleaf]

APPENDIX

The Income Tax Rules, 1982 were framed in Pakistan in pursuance to a new Income Tax Law proclaimed as the Income Tax Ordinance, 1979 which replaces the old Income Tax Act, 1922. The rules pertaining to non-residents to which reference has been made in the main article under the head **Commitment to go by rules**, *are re-produced hereunder:*

Rule-20

Deduction of Head Office expenditure in the case of non-residents

Sub-rule 1: In the case of an assessee, being a non-resident, no allowance shall be made, in computing the income chargeable under the head "Income from business or profession" in respect of so much of the expenditure in the nature of Head Office expenditure referred to in clause (e) of Section 24 as is in excess of the amount computed as hereunder, namely:

(a) an amount equal to the average Head Office expenditure; or

(b) the amount of so much of the expenditure in the nature of Head Office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in Pakistan, whichever is lower.

Sub-rule 2: For the purpose of sub-rule (1) "average Head Office expenditure" means:

(a) in a case where any expenditure in the nature of Head Office expenditure has been allowed as a deduction in computing the income of the assessee chargeable under the head "Income from business or profession" in respect of the income years relevant to each of the three assessment years immediately preceding the relevant assessment year, one-third of the aggregate amount of the expenditure so allowed; and

(b) in case where such expenditure has been so allowed only in respect of the two of the afore-said three assessment years, one-half of the aggregate amount of the expenditure so allowed; and

(c) in a case where such expenditure has been so allowed only in respect of one of the afore-said three assessment years, one-half of the aggregate amount of the expenditure so allowed;

"Provided that where any one of the years involved in working the average Head Office expenditure constitutes a period of either more than or less than twelve months, the expenses for that year shall be pro-rated".

Rule-23

Income from royalties or fees for technical services

For the purpose of sub-section (4) of Section 31, the income of a foreign company by way of royalty or fees for technical services received from a Pakistani concern shall be computed in the following manner, namely:

Sub-rule (1): In case the said income is by way of Royalty:

(a) when received in pursuance of an agreement made before the 8th day of March, 1980 or an agreement made on or after the said date the proposal in respect of which was approved by the Government before the said date, the deductions admissible under Section 31 shall be allowed in accordance with the provisions of the said section; and

(b) when received in pursuance of any agreement made on or after the 8th day of March, 1980 no deduction in respect of any expenditure or allowance shall be made under the said Section 31 from the gross amount of royalty.

Sub-rule (2): In case the said income is by way of fees for Technical Service:

(a) when received in pursuance of an agreement made before the 8th day of March, 1980 or an agreement made on or after the said date the proposal in respect of which was approved by the Government before the said date, the deduction admissible under Section 31 shall be allowed in accordance with the provisions of the said section;

(b) when received in pursuance of an agreement made on or after the 8th day of March, 1980 but before the 4th day of May, 1981, the deductions admissible under Section 31 shall not exceed in the aggregate twenty per cent of the gross amount of such fees; and

(c) when received in pursuance of an agreement made on or after the 4th day of May, 1981 no deduction in respect of any expenditure or allowance, except the following expenditure, shall be made under Section 31 from the gross amount of such fees, namely,

  (i) expenditure incurred in Pakistan on the provision of services of technical or other personnel, including their salaries earned in Pakistan where paid;

  (ii) expenditure incurred in Pakistan in respect of any work done in pursuance of such agreement; and

  (iii) expenditure incurred outside Pakistan in respect of any work done in pursuance of such agreement not exceeding ten per cent of the gross amount of such fees.

Rule-24

Determination of income attributable to operations carried out in Pakistan by non-residents and to transactions with non-residents

Sub-rule (1): In any case in which the Income Tax Officer is of the opinion that the actual amount of the income, profits or gains accruing or arising to a non-resident, whether directly or indirectly through or from any business connection in Pakistan, or through or from any property or asset or source of income in Pakistan, or through or from transfer of a capital asset situated in Pakistan cannot be ascertained, the amount of such income, profits or gains for the purposes of assessment to income tax may be calculated on such percentage of the turnover so accruing or arising as the Income Tax Officer may consider to be reasonable or in an amount which bears the same proportion to the total profits of the business of such person (such profits being computed in accordance with the provisions of the Ordinance) as the receipts so accruing or arising to the total receipts of the business, or in such other manner as the Income Tax Officer may deem suitable.

Sub-rule (2): The profits derived from any business carried on in the manner referred to in Section 79 may, for the purposes of assessment to income tax be determined in accordance with the provisions of sub-rule (1).

TUNISIA:

An Overview of its Tax System

By Jean-Marc Tirard

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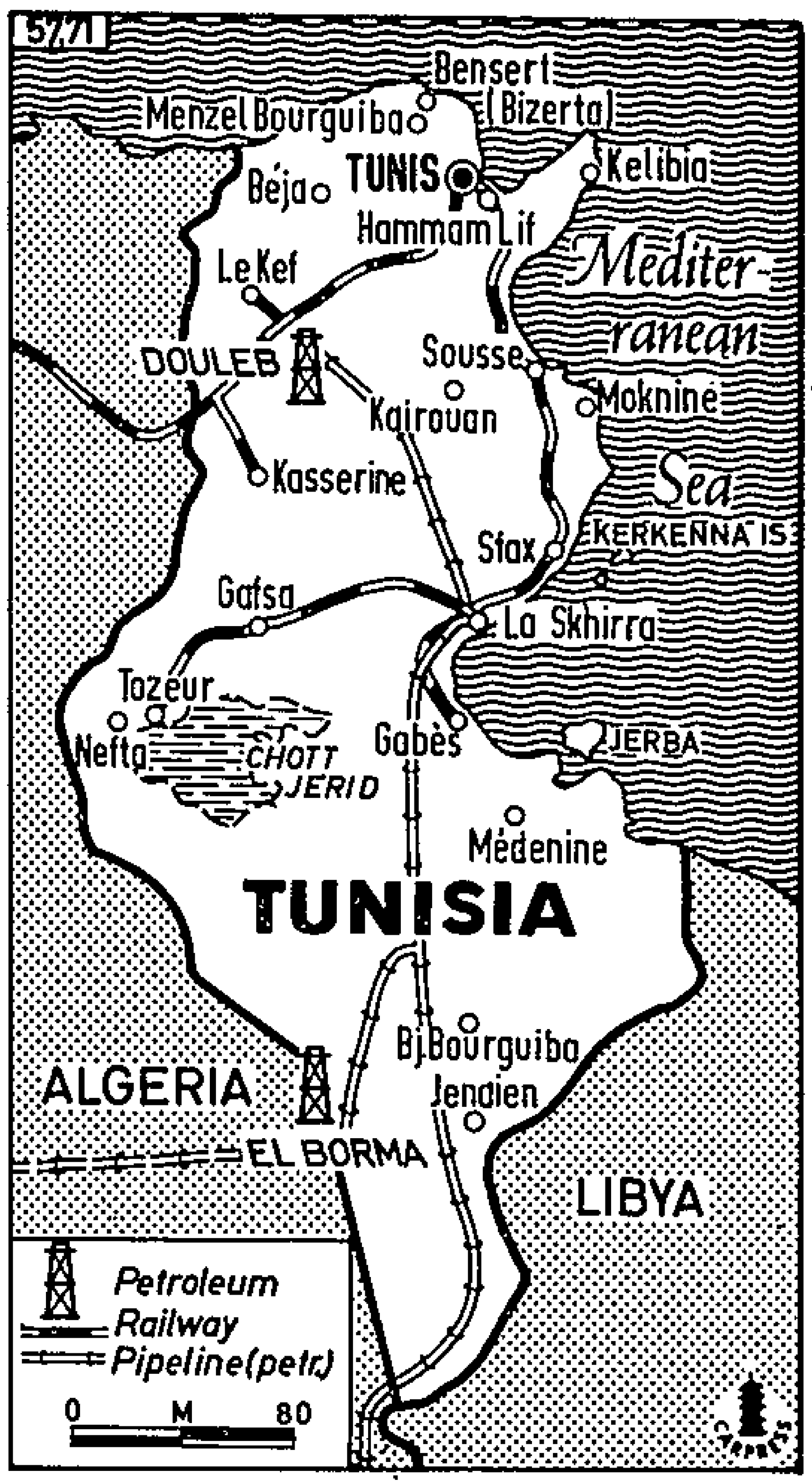
Located in North Africa, at the eastern extremity of the Maghreb geographical area, Tunisia, which from 1881 had been a French Protectorate, obtained its independence in 1956. Although Arabic is the official language, the French language is widely spoken and frequently used in work situations.



Although somewhat limited in surface area (164,150 sq. kilometers) and in human resources (6,500,000 inhabitants), over the past 10 years Tunisia has obtained remarkable results in terms of growth, investment, revenue, and price stability. Despite poorer results in 1982 Tunisia is still counted among those Third World countries having obtained a good measure of success in their struggle for development.

Tunisia is a state where free trade is encouraged. Although there is a certain amount of government intervention, this is limited to infrastructure and to the setting up of guidelines aimed at orienting investment in accordance with economic and social development plans.

In so far as relationships with foreign countries are concerned, Tunisia has demonstrated its dedication to the role it plays as a hub between Western and Arab countries evidenced by agreements with various other governments and by special regulations in this domain.

DIRECT TAX

Business profits

Tunisian tax law draws a distinction between industrial or commercial activities and non-commercial activities. Profits realised in Tunisia by individuals or legal entities, whether Tunisian or foreign, are subject to a profits tax (impôt de la patente) when they are derived from industrial or commercial activities exercised within the context of a business organization characterized by the existence of inventories, business premises, employment of personnel.

The tax is based on net profits, i.e. after deduction of costs and expenses allowed for this purpose. These include operating expenses and depreciation to the extent that these are within general acceptable limits. On the other hand, provisions for future expenses are not deductible, nor is the profits tax itself deductible.

The rate varies according to the person or entity subject to the tax, and on the type of activity. Individuals and partnerships are taxed at a 25% rate (Art. 26.1 of the Profits Tax Code (Code de la Patente)[1] when they exercise an industrial activity, and at a 40% rate (Art. 21.1 of the Profits Tax Code) when their activity is of a commercial nature. Since the enactment of the 1983 Finance Law, stock companies engaged in industrial, tourist or transport activities are subject to a 38% rate, whereas a 44% rate applies to all others (Art. 36ter of the Profits Tax Code).

1. Amended by Art. 16.1 of the Finance Law 1983.

An annual return must be filed and the tax paid in the 3-month period following the date of the end of the fiscal year. During the year, a standard 1% minimum tax based on overall gross turnover (excluding export operations) must be paid at the beginning of each quarter. This standard minimum tax (droit d'exercice) will be set off against the profit tax liability determined at the end of the fiscal year (Art. 4 et seq. of the Profits Tax Code). In addition, two partial instalments, representing 80% of the difference between the profit tax and the standard minimum tax paid in the preceding year, must be paid during the year.

Losses may be carried forward and set off against profits in the 3 succeeding years (Art. 14.1 of the Profits Tax Code).

Foreign companies which have no establishment in Tunisia and which receive certain categories of income (royalties, see definition, below) from Tunisian residents are subject to profits tax according to special regulations. A standard deduction for expenses equal to 40% of the gross amount of remuneration is allowed and the resulting net amount is taxed at the rate of 44%. This form of profits tax is generally known as *impôt de la redevance* (Art. 16bis of the Profits Tax Code).

Individuals or legal entities exercising *non-commercial activities* are subject to a tax on profits (l'impôt sur les bénéfices des professions non-commerciales) which is comprised of a standard minimum tax and of a proportional tax, the latter being levied on the same basis and in the same manner as the profit tax applying to industrial and commercial activities. The general rate is 20%, although reduced rates apply to certain professions.

Individuals or legal entities which are subject to the profits tax or to the tax on non-commercial activities are subject to a "tax on industrial, commercial and professional establishments" equal to 0.2% of turnover. The amount of this tax may not exceed 20,000 DT.

Furthermore a professional training tax (taxe de formation professionnelle) of 2% of the total amount of the salaries paid is due each year.

Tax on investment income

A tax on investment income (l'impôt sur le revenu des valeurs mobilières) applies to dividends, directors' fees and profit shares, and interest on bonds issued in Tunisia. This tax, which is withheld by the distributing company, was raised to 25% on 1 January 1983 for all dividends. Interest on bonds is taxed at a 16.7% or 19.5% rate.

Foreign companies established in Tunisia having no subsidiaries in the country (e.g. companies having a purchasing or sales office or agency) are subject to this tax even though no dividend is paid by the head office (Art. 1 of Decree of 26 December 1935). In this case, the tax is based on a fraction of the foreign company's share capital which is determined by the Finance Ministry on the basis of specific elements chosen on a case-by-case basis. The fraction may be determined by comparing the turnover in Tunisian operations and the international turnover, or by comparing the Tunisian fixed assets and those of the head office, or by comparing the Tunisian and world-wide profits, etc. One can easily understand foreign companies' feelings of insecurity arising from this unpredictable method of taxation.

Interest on claims deposits, guarantees and current accounts is taxed at the rate of 11.5% on the gross amount of interest.

Tax on salaries, wages and pensions

Residents of Tunisia are subject to tax on salaries and wages (l'impôt sur les traitements et salaires) on their world-wide income of such nature, whereas non-residents are taxable on remuneration of their activity performed in Tunisia. Individuals resident or established in Tunisia receiving pensions and annuities are subject to this tax no matter where these incomes are paid.

Taxable income is that which remains after certain deductions, e.g. social security contributions, pension contributions, 10% deduction for professional expenses; for pensions and annuities an additional deduction of 20% is allowed. Tax is levied according to a progressive-rate scale ranging from 0 to 8.9%, and with respect to wages and salaries is withheld by the employer.

State personal levy (Contribution personnelle d'Etat – C.P.E.)

Persons customarily residing in Tunisia are subject to a global income tax based on revenue after deduction of authorized expenses, e.g. 150 DT for married persons, 90 DT for the first child, 75 DT for the second child, 60 DT for the third child, 45 DT for each additional child; premiums paid for life insurance; interest paid on certain debts; and the tax on salaries, wages and pensions. The graduated rate ranges from 0 to 80%. The tax arising from salaries has to be withheld by the employer.

Solidarity contribution

A special "solidarity contribution" is payable by individuals or legal entities that are subject to the tax on salaries, business profits tax, and tax on profits of non-commercial professions. It amounts to 10% of the standard minimum tax for those subject to business profits tax or the tax on profits of non-commercial professions and 5% of the amount of tax on salaries.

INDIRECT TAX

The changes in turnover tax legislation, begun in 1982 by the Finance Law, are replacing progressively the complex array of various and cumulative taxes by a single tax comparable to the European value-added tax. The difficulties encountered by the Tunisian administration in the implementation of this reform, as well as the reticence shown by companies when faced with unfamiliar procedures (according to the tax authorities, not a single company had as of 1 January 1983 voluntarily opted for the new system despite the fact that it is more advantageous in certain cases), will perhaps lead Tunisian legislators to slow down the announced "fiscal reform" process.

Production tax

The most important of the turnover taxes is the production tax (taxe à la production) to which all individuals or companies who transform, produce or import goods in Tunisia are subject. The 1983 Finance Law has extended coverage to wholesale dealers, hotel and tourist businesses and construction companies, activities previously subject to the tax on services.

The normal 14.4% rate is applied to a tax base consisting of the amount invoiced to customers plus the tax itself (i.e. an effective rate of 16.82%). However, certain sectors may benefit from reduced rates. These include:

- construction 12%
- hotel and tourism 10%
- freight 11%

The tax is somewhat similar to the value-added tax system in Europe in that it is ordinarily invoiced to customers at the time of sale and the amount payable to the Government is reduced by both the production tax paid on purchases and the tax on services, but only to the extent they are incurred in connection with the acquisition of goods and services directly related to the production of goods.

Tax on services

Individuals and companies exercising a commercial activity other than those subject to the tax on production or who carry out certain specified operations are subject to this tax. The tax on services is due whenever the activity, whether service rendered, rights sold or objects rented or hired, occurs in Tunisia. The taxable base consists of the total remuneration for services including the tax itself.

The rate is 8% (i.e. a real rate of 8.69%). The tax is ordinarily invoiced to the beneficiary of the service. In calculating the tax due on a particular service, the base is reduced by the cost of services subcontracted on which the tax has previously been levied. In settling the tax liability no deductions are made for taxes incurred by the provider of the services.

Consumption tax (taxe de consommation)

Certain categories of products, as well as their importation into Tunisia, are subject to sales tax. This concerns mainly food products and alcohol, as well as certain luxury items (jewellery, audiovisual equipment, antiques, etc.). This tax, the rates of which are either 8, 16 or 23%, is calculated on the same basis as production tax.

Registration taxes

In addition to turnover taxes, indirect taxes include duties pertaining to the mandatory registration of certain legal instruments and the duties pertaining to them. Property transfer taxes vary from 1.4% to 18.8% according to the nature of the property acquired and the nature of the agreement. Formation of companies is subject to tax generally fixed at 1.4% of the total amount of fixed and movable assets, after deduction of liabilities. Lastly, all contracts signed in Tunisia, except those relating to technical studies, are subject to a 2.2% tax based on the total value of the contract. The 1983 Finance Law addendum has exempted subcontracting contracts (when related to an initial contract signed in Tunisia) from the 2.2% tax. This measure eliminated a situation of double taxation, which had considerable impact on the cost price of companies operating in Tunisia. The same Finance Law addendum indicates a loosening up of the definition of technical studies, which is subject to a fixed registration tax of 3 DT. Clarification from the tax authorities on this point is expected.

INTERNATIONAL ASPECTS OF TUNISIAN TAXATION

Fiscal regulations applicable to foreign companies operating in Tunisia may differ from the internal regulations described above, pursuant to bilateral tax treaties intended to avoid double taxation. The increasing number of tax treaties signed by the Tunisian Government clearly indicates its willingness to take into account fiscal factors in dealing with foreign countries.

To date, tax treaties are in force with West Germany, Austria, Belgium, Denmark, France, Italy, Morocco, Norway and Sweden. Treaties with Libya, Canada and the United Kingdom have been signed but are not yet in effect. Negotiations for a treaty are under way with the United States.

Registration requirements

Foreign companies wishing to set up and pursue activities in Tunisia must obtain prior authorization from the "Direction du Commerce" of the National Ministry for the Economy. A "Carte de Commerçant" (commercial activity card) is then issued, authorizing the company to commence activity. This permit is issued for a period of time varying from 1 to 5 years and is renewable.

In practice, Tunisian authorities use this formality as a means of making foreign investments more "Tunisian". Thus, the permits are, in general, only issued to those foreign investors who operate in Tunisia through the intermediary of a Tunisian company, of which at least 50% of the capital is held by Tunisian citizens. However, if Finance Ministry approval is obtained, the following categories may dispense with this formality:

- companies operating within the context of contracts financed by public or private funds originating from the companies' country of origin (Art. 4.9° of Decree-Law 61.14 of 30 August 1961);
- companies which are subcontractors of Tunisian companies (Art. 4.4.° of Decree-Law 61.14 of 30 August 1961).

Industrial projects responding to the country's economic needs, and exporting companies pursuant to the Law of

27 April 1972 (see below: 'Investment Incentives'), are also exempt from this formality.

Companies carrying out activities in Tunisia under a temporary contract must obtain a permit even though they do not set up a branch or subsidiary.

Any foreign company wishing to operate in Tunisia subsequent to a contract signed with the Tunisian client must obtain approval of this contract through the Banque Centrale de Tunisie. This approval determines, notably, the amount of currency which may be repatriated.

If the proposed activity is to be performed through an establishment, the establishment must be registered in the "Registre du Commerce et des Sociétés" and declared to the tax authorities.

Legal business entities

General principles of Tunisian company law are quite similar to French company law. The Tunisian commercial code provides for 5 types of companies: "société anonyme" (public limited liability company), the "société à responsabilité limitée" (private limited liability company), the "société en commandite" (limited partnership), the "société en participation" (joint venture) and "the société en nom collectif" (general partnership). The two companies most commonly adopted by foreign investors are the "société à responsabilité limitée" (SARL) (Arts. 149-176 of the Commercial Code) and the "société anonyme" (SA) (Arts. 48-136 of the Commercial Code). A SARL requires a minimum of two associates and the capital must be at least 1,000 DT. An SA should be constituted by at least 7 stockholders. No minimum capital is required.

Exchange control regulations

Any operations requiring transfer of funds between Tunisia and a foreign country, as well as any transfer of Tunisian assets between non-residents, must have prior authorization of the Central Bank of Tunisia. This Central Bank approval specifies under what conditions profits and dividends may be transferred.

Taxation of profits

According to Tunisian legislation a foreign corporation is treated as having a permanent establishment in Tunisia and, therefore, is subject to business profits tax if it:
- exercises commercial or industrial activity in Tunisia in an established place of business; or
- carries out temporary or supervisory activities related to a construction project in Tunisia, for whatever period of time (Art. 20 of Law 74-101 of 25 December 1974).

Companies resident in a country which has signed a tax treaty with Tunisia are subject to the business profits tax only to the extent that they have a permanent establishment in Tunisia. The term "permanent establishment" as defined by treaties is more restrictive than that defined by domestic legislation.

It should be noted that the definition of the term "permanent establishment" varies from one treaty to another. However, each treaty lists the following as constituting a permanent establishment:
- a place of management;
- a branch;
- an office;
- a factory;
- a workshop;
- a mine, quarry or any other place of extraction of natural resources.

The following are also specifically excluded as being permanent establishments:
- the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise (except in the treaty with France).

Under the treaties, construction sites and erection operations may or may not constitute a permanent establishment depending on the size of the project and its term to completion. All the tax treaties consider these installations as permanent establishments when they exceed 6 months. For durations of less than 6 months, the treaties with Morocco, Belgium, West Germany, Norway and Sweden consider these installations as being permanent establishments if the assembly or supervisory expenses relating thereto exceed 10% of the sales price of the equipment. The same applies to the treaties with France, Austria and Denmark except that the qualifying period is from 3 to 6 months.

Insofar as services rendered by the head office expressly for its permanent Tunisian establishment are concerned, certain tax treaties (West Germany, Italy, France and Morocco) indicate that the head office may charge its Tunisian establishment for those services rendered outside Tunisia directly applying to the project for an amount which includes profit.

Insofar as the expenses of the head office itself are concerned, i.e. general managerial and administrative expenses relative to the overall operation of the company, the Tunisian tax authorities, as well as tax treaties, allow expenses to be charged to the Tunisian establishment by some pro rata method of allocation. Tunisian law limits the amount of head office expenses billed to the permanent establishment to 10% of the turnover of the latter and requires that they be justified by valid documents. Despite the fact that the 10% turnover limit is never specified in treaties the tax authorities have shown a tendency to apply internal legislation and to reject items which result in head office expenses exceeding 10% of the turnover. Companies must thus attempt to convince the Tunisian tax authorities that the deductions are legitimate.

Foreign companies operating in Tunisia and having no permanent establishment may be subject to the business profits tax withheld at source (impôt de la redevance – see above), under internal legislation or the similar tax provided for in a treaty.

Taxation of investment income

Dividends

The term "dividends" as used in tax treaties means income from shares, not being debt-claims, participations in profits, as well as income from other corporate rights assimilated to income from shares by Tunisian tax regulations.

Such a definition embraces the concept of dividends as indicated in Tunisian legislation, except that it expressly excludes interest on loans and bonds, rendering the latter taxable under treaties as interest and not as dividends. The various tax treaties provide a limitation of the tax rate applicable in Tunisia to dividends accruing to residents of those countries having signed the treaties (see chart below).

Tax credits are allowed under all tax treaties, offsetting tax withheld in the country of payment.

It should be noted that the French treaty contains a matching credit clause:

Art. 29 allows tax credits based on the following formula:

$$\frac{100-(25+T)}{2}$$

T is equal to the rate of tax withheld in Tunisia. This clause is no longer advantageous to most French investors because tax is withheld in Tunisia, since 1 January 1983, at a rate of 25%. Only those subject to the advantageous dividend tax (see "regulations favorable to investments", below) at a 6 or 8% rate still benefit from a matching-credit clause which is the following:

$$\frac{100-(20+T)}{2}$$

Interest

The tax treaties define "interest" as income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and from debt-claims of every kind, as well as all other income assimilated to income from money lent by the taxation laws of Tunisia.

Income tax is withheld at source in accordance with treaty rates (see chart). The treaties allow a tax credit with respect to the tax paid in Tunisia.

Royalties

Tunisian law provides a very wide definition of "royalties" (redevances). Art. 16bis of the Business Profits Tax Code (Code de la Patente) includes under this term payments of any kind for the granting of licenses to use patents, designs and models, plans, secret formulae or processes, trademarks, as well as for a license to use industrial equipment, and for information concerning industrial or commercial experience or payments for economic and technical studies. Under Art. 50 of Finance Law 81-100 (31 December 1981), all payments for technical assistance are also included.

Treaty definitions of royalties are often restricted. In fact, simple technical assistance is not dealt with in any tax treaty signed by Tunisia (except with Belgium). Moreover, concerning Italy and Belgium, Tunisia does not consider that payments for economic and technical studies constitute royalties. With respect to the tax treaty signed with West Germany, payments for the use of industrial equipment are not considered to constitute royalties. However, the Tunisian tax authorities have a tendency to apply Tunisian law to the detriment of the treaty definitions, and to subject unduly certain categories of payments of tax. Here again, foreign companies might have to argue for the strict application of treaty provisions.

INVESTMENT INCENTIVES

Plans for development in Tunisia require large investments. For this reason, steps have been taken to attract foreign companies. Two investment laws offer particular benefits:

- Law 72-38 concerning exporting companies ; and
- Law 81-56 concerning manufacturing companies.

Regulations governing exporting companies

Special regulations were set up by Law 72-38 of 27 April 1972 applying to companies which export 100% of their production and have been approved by the National Economy Ministry upon recommendation from the Investment Promotion Agency, which has been set up for this purpose.

The main tax advantage granted to such companies is an exemption from the business profits tax for the first 10 years of activity. In the following 10 years this tax is due at a reduced rate of 10%.

For the first 20 years of activity, these companies also enjoy the following additional advantages:

- exemption from tax on interest due on loans made for creating or increasing the investment;
- fixed duty of 3 DT for registration of all deeds creating the company, establishing capital contributions, modifying statutes, or establishing merger terms;
- reduced withholding rate of 6% on dividends remitted on nominative shares and of 8% on bearer shares;
- reduced registration tax rates on transfer of assets;
- exemption from customs duties and turnover taxes due on importation or purchase from local manufacturers of goods necessary to their operations;
- reimbursement of custom duties and turnover taxes due on purchase of goods from "non-manufacturers".

The exchange control benefit granted to these companies, provided that they are considered as non-resident, is that they have no obligation to remit to Tunisia any profits earned abroad. These companies are deemed

CHART: TUNISIAN TAX ON PASSIVE INVESTMENT INCOME

	DIVIDENDS	INTEREST		ROYALTIES						
		On bonds	Others	Copyrights	Patents	Trademarks	Secret formulae or processes	Information concerning industrial, commercial, or scientific experience	Use of industrial, commercial or scientific equipment	Technical and economic studies
AUSTRIA	• 10% if the beneficiary is a company which holds directly at least 25% of the capital of the company paying the dividends; • 20% of all other cases	20%	11.5%	10%	15%	15%	15%	15%	15%	15%
BELGIUM	15%	15%	11.5%	5%	15%	20%	15%	20%	20%	N/A[1]
DENMARK	15%	12%	11.5%	15%	15%	15%	15%	15%	15%	15%
FRANCE	Tunisian rates	12%	11.5%	5%	15%	20%	15%	15%	20%	15%
ITALY	15%	12%	11.5%	5%	12%	16%	12%	12%	16%	N/A
MOROCCO	Tunisian rates	Tunisian rates	11.5%	Tunisian rates	Tunisian rates	Tunisian rates	Tunisian rates	Tunisian rates	Tunisian rates	Tunisian rates
NORWAY	20%	12%	11.5%	5%	15%	20%	15%	15%	20%	15%
SWEDEN	• 15% (as Austria) • 20% in all other cases	12%	11.5%	5%	15%	15%	15%	15%	15%	15%
WEST GERMANY	• 10% (as Austria) • 20% in all other cases	10%	11.5%	10%	15%	15%	15%	10%	N/A	10%

1. Except technical assistance: 15%.

to be non-resident when at least 66% of their share capital is held by non-residents and has been contributed by the importation of convertible currencies.

Export financing institutions

In order to facilitate financing of export-oriented industries, Law 76-63 of 12 July 1976 established a special regime encouraging the establishment of financing and banking institutions dealing essentially with non-residents. The main inducements from the point of view of the foreign banks for the establishment of offshore banking operations are freedom from business profit tax during the first 10 years of operation and exemption from income tax on interest revenue and from loans and deposits. A reduced 20% rate applies during a further 10-year period.

Partial exporting

Law 81-56 of 23 June 1981 establishes regulations concerning companies exporting a part of their manufactured goods. Such companies are subject to a reduced rate of 20% on profits from exports. In addition, they are exempt from turnover tax on purchases of goods required for manufacturing goods for export. Regulations concerning duty-free warehousing are also more advantageous.

New industrial investments

The new manufacturing industry regulations set up by Law 81-56 of 23 June 1981 encourage investments in manufacturing industries and industrial decentralization. Industrial sectors concerned are listed in a decree and include most industrial activities.

To qualify, the investment must obtain the approval of the National Economy Ministry, after recommendation from the Agency for the Promotion of Investments, and it must be for construction of new plant, result in creation of at least 10 permanent jobs, and be financed by at least 30% equity capital. Investments are classified in various categories depending on the number of jobs created and location chosen.

Approved investments are accorded the following advantages:

- partial exemption from business profits tax according to the number of jobs created, varying from 40% to 90%; the exemption is allowed for a period of 5 to 10 years, depending on the location selected;
- a fixed 3 DT charge for registration of legal documents for formation of the company;
- partial reduction of income or profits invested by an individual or legal entity taxable in Tunisia, for subscription to formation capital, as well as for capital increases occurring within a 5-year period from the date of the formation of the company;
- suspension of customs duties and turnover tax on acquisition of equipment.

Additional advantages may be allowed depending on the location selected (exemption from tax on investment income in the case of profit distribution, from professional training tax, etc.). Non-residents participating in an approved investment are guaranteed unrestricted transfer of amounts arising from the sale or liquidation of their investments (including capital gains).

Singapore: Car Tax Increases

Who dares to complain about high car tax?

A press release of the Ministry of Communications of 15 October 1983 gives an overview of the taxes levied on motorcar owners

After a slow-down in 1973-1978, the increase in the number of cars has started accelerating again. Over the last three years (1980-1982), the number of cars have increased by 6.8%, 6.6% and 11.5% respectively. This year the increase in the first six months is at an annualised rate of 13.6%. At this rate, the number of cars on the road will double in five years. The rapid increase in the number of cars is due to sizeable increases in disposable income, arising from reduced income tax and increased salaries over the past five years. This high growth rate in car population cannot continue. In spite of extensive building of roads, expressways and flyovers, traffic jams are beginning to be more frequent again. Car parks in housing estates are unable to accommodate the sudden increases in car population. We cannot have more cars than our limited land and roads can bear. Otherwise paralysing traffic jams with increased travelling time for everybody will result, bringing adverse consequences on our economy.

The rapid increase in the number of cars must be slowed down. Cost of ownership and of usage must reflect their total social cost to the community. To achieve this objective, the government has decided to increase the additional registration fees, the preferential additional registration fees and road taxes with effect from 17 October 1983. The increase will be as follows:

(a) additional registration fees (ARF) for passenger cars from 150% to 175% of open market value (OMV);

(b) the preferential additional registration fees (PARF) for passenger cars will be raised by 10% across the board as follows:

Up to 1000 cc from	35% of ARF to 45% of ARF
1001 – 1600 cc from	40% of ARF to 50% of ARF
1601 – 2000 cc from	45% of ARF to 55% of ARF
2001 – 3000 cc from	50% of ARF to 60% of ARF
Above 3000 cc from	55% of ARF to 65% of ARF

(c) annual registration fees (road tax) for private passenger cars will be increased by 30% across the board as follows:

Up to 1000 cc from 40 cents per cc to 52 cents per cc
1001 – 1600 cc from 50 cents per cc to 65 cents per cc
1601 – 2000 cc from 60 cents per cc to 78 cents per cc
2001 – 3000 cc from 70 cents per cc to 91 cents per cc
Above 3001 cc from 51 cents per cc to $1.30 per cc
Diesel cars will pay six times the above rates;

(d) annual registration fees (road tax) for company registered cars will be double the above rates for private cars.

The registration fees for light goods vehicles (less than 3000 kg maximum laden weight) will also be increased from $5,000 to $7,000.

There is one special category of light goods vehicles – the panel vans which are almost perfect substitutes for passenger cars. They are really station wagons with the back portion panelled up to carry goods. But because of the lower taxes levied on them, they have been used increasingly as substitutes for passenger cars. The number of panel vans have increased by 1200% over the last five years. It is therefore necessary to classify this category of light goods vehicles as goods-cum-passenger vehicles. At present, panel vans consist of the following five models: Datsun 120Y, Toyota Corolla, Ford Escort, Suzuki SJ 410 and Suzuki LJ 80. With effect from 17 October 1983, these panel vans will be re-classified as goods-cum-passenger vehicles. The additional registration fees for new panel vans and annual registration fees (road tax) for panel vans will be the same as other goods-cum-passenger vehicles. All other categories of vehicles including heavy goods vehicles, goods-cum-passenger vehicles, school buses and taxis are not affected by the above tax increases.

SIERRA LEONE:

New Investment Regulations

By Servaas van Thiel

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In July 1983 Sierra Leone enacted The Development of Industries Act, 1983[1] *(hereinafter the "Act") in order to regulate and stimulate local, expatriate and foreign investment. The Act repeals the Development Act, 1960*[2] *as far as there is an inconsistency. However, any existing company shall continue to enjoy the benefits to which it already was entitled under the 1960 Act.*

REGISTRATION AND APPROVAL

Every new or existing industrial establishment[3] must be registered with the *Industries Development Department,* a specialized body composed of civil servants of the Ministry of Trade and Industry (Arts. 4(9) and 30).

Upon registration the Minister of Trade and Industry has the power to require the submission of annual financial statements, accounts and reports of major developments and changes. He can also require inspection of records and offices and demand interviews. Finally, he can make the registration conditional upon adherence to previously submitted project plans (Art. 30).

Apart from registration, the Industries Development Department's functions include the stimulation of investment and industrial development, the establishment of a system of industrial licensing for the import of plant, machinery, raw materials and spares, the establishment of a Stock Exchange in cooperation with the Bank of Sierra Leone and finally the annual release of an Investment Guide (Arts. 4 and 6).

Separate from the Industries Development Department a *Project Approval Committee* (hereinafter the Committee") is created in which various ministries as well as the Bank of Sierra Leone, the Commissioner of Income Tax and the Chamber of Commerce are represented (Art. 22).

All applications to establish, expand or modernize industrial projects must be submitted to approval to the Minister for Trade and Industry who is the chairman of the Committee (Arts. 20 and 22). The Committee taking decisions by simple majority and a quorum of 6 has the power (Arts. 23 and 25):

- to reject or approve application;
- to determine the extent of the incentives granted, e.g. the period of the tax holiday and the rate of customs duties;
- to review the progress of an improved industrial project;
- to suspend or withdraw approval;
- to withdraw any incentives or guarantees granted under the Act (Art. 19).

At the moment of application substantial information on the nature and the location of the project, including a comprehensive feasibility study, must be disclosed to the Committee (Art. 21). The Committee as well as the Minister may require any additional information deemed necessary (Arts. 24 and 33).

On approval of an industrial project, a development certificate will be issued containing particulars of the project,[4] including production targets, and the benefits granted.

If the Committee is of the opinion that an industrial establishment either fails to comply with national legislation or fails to produce targets or deliver products as specified in the certificate, it may, by written notice, demand compliance within a certain period, not less than 30 days. If the industrial establishment does not satisfy the Committee within the specified period, the development certificate may be cancelled and the benefits may be withdrawn (Art. 31).

In such a case the certificate shall be deemed never to have applied which incurs the liability to pay customs duties and taxes accordingly. However, if cancellation of the certificate takes place at the request of the industrial establishment concerned, the Committee shall specify the date from which the cancellation shall take effect, a date not earlier than the date of the request (Art. 32).

INVESTORS ELIGIBLE FOR BENEFITS

Although every new or existing industrial establishment must be registered and approved, the listed benefits are only available to the following industries[5] (Art. 7):

(a) export-oriented resource-based industries;
(b) resource-based industries designed to meet local requirements ;

1. The Development of Industries Act, 1983 Gazette No. 42 of 21st July 1983, Art. 1, provides that the "Act shall come into operation on such date as the Minister may by Notice published in the Gazette appoint".
2. The Development Ordinance 1960 (Act No. 26 of 1960) repealed by Art. 39.
3. "Industrial establishment" means an enterprise:
(a) engaging in the processing, manufacturing or servicing of an industrial product where the fixed assets exceed 100,000 Leones in value; or
(b) engaging 20 or more employees with industrial machinery and plant run by motive power (Art. 2).
4. The Certificate will list such specified information as necessary imports, expatriate personnel, period of the tax holiday and other concessions or guarantees granted etc. (Arts. 26 and 27).
5. "Industry" means the commercial transformation of raw materials or semi-processed raw materials into finished or semi-finished products and also means the assembling of inputs into finished or semi-finished products (Art. 2).

(c) building material industries;
(d) export-oriented industries partly based on imported materials and services; and
(e) import-substitution industries with capacity to save or earn foreign exchange and producing domestic value added measured in world market prices exceeding 30% of the finished product value.

In granting the benefits, priority will be given to industries mentioned under (a) and (b) (Art. 8) and in general to Sierra Leonean[6] enterprises (Art. 14(a)).

A further provision (Art. 36) requires that in order to qualify for the benefits, a company should be incorporated in Sierra Leone under the Companies Act (Cap. 249) or should be exempted from incorporation by an order published in the Gazette.

BENEFITS

There are general benefits that can be granted to all approved industrial projects and additional benefits for various types of approved projects. The general benefits consist of a basic guarantee, incentives upon import and tax incentives.

The **basic guarantee** provides protection and security against nationalization except in the interest of national security and subject to the payment of prompt, fair and adequate compensation (Art. 9). Although no further definition of the terminology is given, it can be expected from the wording of the guarantee that the concepts of nationalization and compensation are used in their classic form.[7] Whenever a nationalization (or other) dispute that arises between the Sierra Leonean government and a foreign investor cannot be solved through amicable settlement, the Act provides for international dispute settlement, either within the framework of any bilateral or multilateral agreement[8] or within the framework of the 1965 World Bank Convention on the Settlement of Investment Disputes.[9] If no provision under such agreements exists, the dispute can be referred to any other international procedure to which the parties mutually agree (Art. 37).

The **incentives upon import** include preferential treatment with respect to the granting and processing of import licenses as well as partial or total exemption from customs duties payable on capital equipment, raw materials and intermediate goods (Art. 10).

However, the exemption from customs duties will not be granted if the project can be financially viable while using:
- labor-intensive techniques instead of imported capital equipment; or
- local sources instead of imported raw materials; or
- intermediate goods inhibiting the creation of domestic value added.

Besides this, whenever an industrial establishment wants to dispose of goods which have been imported free of duty, it needs the consent of the Comptroller of Customs and Excise.[10] The duties have to be paid after all and the goods will have to be made available for sale to the public (Art. 28).

The **tax incentives** include the following:
(1) The normal rates of capital allowances[11] for plant and machinery are reduced to 25% (initial allowances) and 10% (annual allowances); however, an additional investment allowance of 16% will be granted to approved enterprises and this allowance may be ignored for the purposes of calculating balancing allowances and charges subsequently (Art. 10(c), Art. 15).
(2) There is an exemption from income tax and surtax[12] for a maximum period of 5 years and to a maximum amount of 150% of the original capital invested (tax holiday of Art. 10(d) and (e)). However, the net profits earned during the tax holiday period must be credited to a special reserve account which may only be used for reinvestment. The profits credited to this account are not taxable to the extent that they are not effectively distributed during the tax holiday period. During this period and the 5 subsequent years the industrial establishment has to deliver, upon every distribution of profits, a copy of its special reserve account to the Commissioner of Income Tax.
(3) Losses incurred during the tax holiday period may be carried forward and set off against profits for a maximum period of 5 years following the expiry of the tax holiday period (Art. 16).
(4) Research expenditure on behalf of an approved project is tax deductible (Art. 18).

The **additional incentives** include:
(1) for any industrial establishment utilising foreign investment or a significant amount of expatriate capital (Art. 17):
   (a) the right to remit, on cessation of business interests, the value of such capital; however, this remittance is subject to applicable foreign exchange control;
   (b) the right, on application, to remit any accrued profits or dividend during the 12-month period immediately following the end of the financial year to which the application refers;
(2) for any industrial establishment exporting an approved percentage of its products (Art. 11):

6. "Sierra Leonean enterprise" means an industrial establishment in which the ownership is vested in the citizens of Sierra Leone or a company in which the controlling share is held by indigenous citizens of Sierra Leone (Art. 2).
7. The so-called "Hull doctrine", as introduced by the U.S.A. during its pre-war dispute with Mexico, prohibits nationalization except for reasons of public utility and against the payment of prompt, adequate and effective compensation. See also the Fifth Amendment to the Constitution of the U.S.A.: ". . . nor shall any person . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without compensation".
8. The 1965 Treaty between Sierra Leone and the Federal Republic of Germany concerning the encouragement and reciprocal protection of investments refers in Art. 11 to international arbitration (Bundesgesetzblatt Vol. II 1-10-1966, No. 48 at 861).
The 1981 Treaty between Sierra Leone and the U.K. refers, in Art. 8, to the International Centre for Settlement of Investment Disputes (see note 9) (U.K. Treaty Series No. 31 (1981), CMD 8246).
9. This Convention of 18 March 1965 establishes an International Centre for the Settlement of Investment Disputes between States and nationals of other States (I.C.S.I.D.). It is reproduced in 4 *International Legal Materials* of 1965 at 532.
10. The Comptroller of Customs and Excise has the same meaning as under the Customs Act (Cap. 271).
11. See Income Tax Act (Cap. 273) 1962.
12. See Surtax (Temporary Imposition) Act, 1968 (Act No. 14 of 1968).

(a) eligibility for application for export credit guarantee schemes established by the Bank of Sierra Leone;
(b) export tariff exemptions;

(3) for any industrial establishment providing training facilities or incurring training expenses for Sierra Leonean citizens (Art. 12):
(a) the right to deduct such expenses from taxable income;
(b) an exemption from payroll tax[13] for any instructor hired for such training;

(4) for any industrial enterprise located outside Freetown (Art. 13):
(a) eligibility to obtain loans from the National Development Bank of Sierra Leone up to 50% of the cost of the project;
(b) eligibility to lease of land or rental of any factory premises or office facilities in the Provinces;
(c) the use of advisory services of the Government;

(5) for any Sierra Leonean enterprise (Art. 14)[14]:
(a) priority in granting approval for the project;
(b) exemption from payroll tax for foreign and expatriate[15] employees;
(c) eligibility to obtain loans from the National Development Bank up to 75% of the cost of the project.

FRAUD AND DISPUTE SETTLEMENT

Persons who fraudulently make false statements or omissions or otherwise contravene the Act shall be guilty of an offense and liable to a fine not exceeding 5,000 Leones or to a term of imprisonment of a maximum of 5 years, or both. In the case of a continuing offense a daily fine of 100 Leones can be imposed (Art. 34). Settlement of disputes, if local remedies are not sufficient, can take place, as already indicated, through international arbitration under any bilateral agreement, the I.C.S.I.D. or any ad hoc international arbitration to which both parties agree (Art. 37).

13. See Payroll Tax Act, 1972 (Act. No. 16 of 1972).
14. See note 6.
15. Expatriate means a non-citizen registered under the Non-Citizens (Registration, Immigration and Expulsion) Act 1965 (Act No. 14 of 1965).

Hong Kong: Election for Separate Taxation of Spouses

A Bill to amend the Inland Revenue Ordinance (Inland Revenue (Amendment) (No. 5) Bill 1983) was published in the Hong Kong Gazette early in December 1983. It aims at the introduction of changes with respect to the taxation of husbands and wives starting from 1 April 1984.

Under current income tax law the responsibility to complete income tax returns and to pay tax with respect to income of a wife lies with her husband, provided that they are not living apart. However, equal treatment of married and single women requires separate taxation of married women and it has in particular been the Women's Liberal Movement which has been most articulate in this respect and which has put pressure on the Government to publish amending legislation as early as possible.

The main object of the Bill is to permit spouses – if they so elect – to file joint tax returns and to bear their own respective shares of total tax liability separately. The achievement of this object involves the repeal and the replacement of those provisions in the Inland Revenue Ordinance that deem the income of the wife to be that of her husband or that deem a wife to be one and the same person as her husband for purposes of the salaries tax, the profits tax and the personal assessment (i.e. the income tax assessment on total income).

It also requires the modification of provisions relating to current methods of computation, assessment and collection of tax and of tax administration. The proposed amendment, however, merely enables the wife to be separately assessed, and there will be no alteration to the total tax bill paid by a married couple. Consequently, the changes proposed by the Bill will have no public revenue implications and the number of revenue staff to be additionally hired will depend on the number of elections for separate assessment which at this moment cannot yet be anticipated with any degree of certainty. A reasonable estimate of the cost of these additional requirements is about HK$750,000 per year.[1]

In his Budget Speech for 1983-84 the Financial Secretary, Mr. John Bremridge, on 23 February 1983 remarked that with respect to the election provision under which separate taxation would be permitted, he was warned by one of his Chinese advisers – a woman – that the proposals to permit an election for joint returns and separate payment might not be viewed with favor in many Chinese families. He therefore announced that he would observe the course of the debate and only if there were a clear consensus in favor of the new measures, with no major objections, would the amending legislatrion with regard to the election provision be enacted.[2]

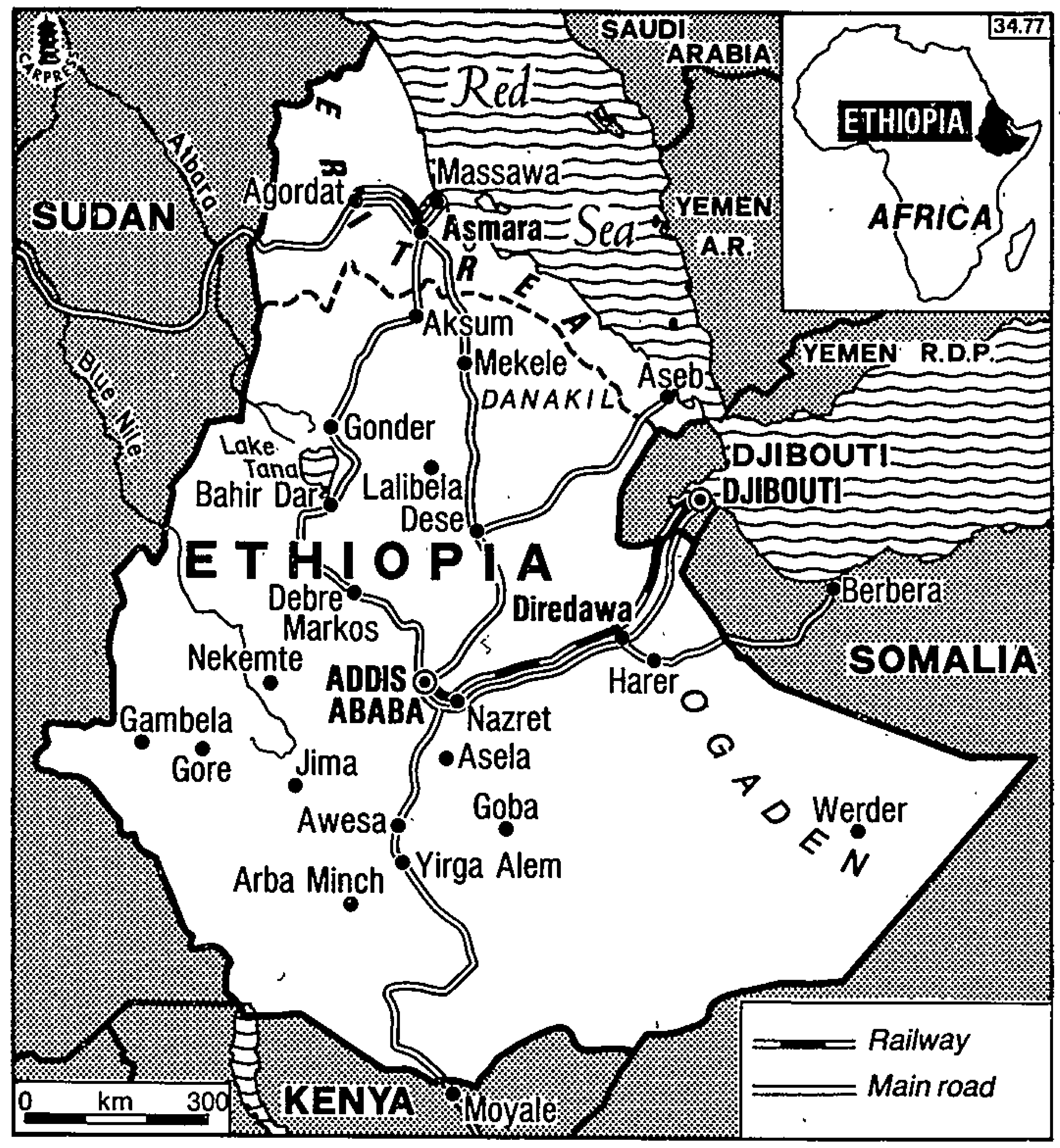
1. See Explanatory Memorandum to the Bill.
2. See "Hong Kong: Budget 1982-83" in 36 *Bulletin for international fiscal documentation* 6 (1982) at 274 and "Hong Kong: Budget 1983-84" in 37 *Bulletin for international fiscal documentation* 6 (1983) at 270.

Ethiopia:

Joint Venture Legislation

The Provisional Military Government of Socialist Ethiopia has issued a Joint Venture Establishment Proclamation 235/1983 for the purpose of the development of the national economy and the achievement of higher living standards for the Ethiopian people. The Government realizes that the participation of foreign capital and the transfer of foreign technology are of paramount importance for achieving this goal.

The Ethiopian Chamber of Commerce kindly sent an English translation of Proclamation 235/1983 for publication in the Bulletin for International Fiscal Documentation.



CHAPTER ONE
GENERAL

1. Short title

This proclamation may be cited as the "Joint Venture Establishment Proclamation No. 235/1983".

2. Definition

In this Proclamation:

1) "Supreme Council" means the National Revolutionary Development Campaign and Central Planning Supreme Council;

2) "Joint venture agreement" means the agreement signed at the time of the formation of the joint venture;

3) "Foreign exchange regulations" means any regulations and directives issued under the Monetary and Banking Proclamation No. 99/1976.

3. Activities that may be undertaken by joint ventures

1) Joint ventures may invest in and undertake activities which introduce technology and know-how into the country which have positive foreign exchange impact or which otherwise make positive contributions to economic and social development and which, in addition, create employment opportunities in the country.

2) Notwithstanding sub-article 1 of this Article, joint ventures shall not, unless the Council of Ministers decides otherwise, be permitted to invest in precious metals, public utilities like electric light and power, telecommunication and water, banking insurance, transport and domestic trade.

CHAPTER TWO
FORMATION OF JOINT VENTURES

4. Participation in joint ventures

1) A joint venture may be formed jointly by Ethiopian public capital and foreign private or public capital.

2) The Supreme Council shall appoint the relevant government organ to be a party to a joint venture agreement representing the Ethiopian Government.

3) Unless the Council of Ministers determines otherwise, the share of the Ethiopian shareholder shall not be less than 51% (fifty-one percent).

4) Subject to sub-article (3) of this Article, the exact amount of the shareholding of the Ethiopian shareholder and that of the foreign shareholder or shareholders shall be fixed in the joint venture agreement.

5. Duration of joint venture

1) Subject to sub-article 2 of this Article, the duration of a joint venture shall be fixed in the joint venture agreement.

2) Unless otherwise approved by the Council of Ministers, the duration of a joint venture shall not exceed 25 years.

3) The Government of Socialist Ethiopia shall protect the right of ownership of the shares held by the foreign shareholder for the duration of the joint venture fixed in accordance with sub-article 1 of this Article.

4) If, for reasons of national interest as determined by the Council of Ministers, the Government has to purchase all the shares, it has to pay a fair and equitable price on the basis of the books of accounts of the joint venture and payment shall be made in the currency of investment within a reasonable period of time.

6. Forms of contribution to share capital

1) Contribution to share capital may be made in cash or in kind.

2) Cash contributions by the foreign partner shall always be in freely convertible currency.

3) The type of contribution in kind, the currency and the method of valuation thereof shall be agreed upon in the joint venture agreement.

7. Share capital and par value

1) The share capital as well as the par value of the shares of the joint venture shall be determined in the joint venture agreement.

2) No joint venture shall be registered unless at least 25% of the share capital has been paid up.

3) In the event that the full share capital has not been paid up at the time of registration, the period for the payment of the remaining part shall be determined in the joint venture agreement.

8. Application for investment in joint ventures

1) Any investment application for participation in joint ventures shall be submitted to the Supreme Council in the form prescribed by the latter.

2) The Supreme Council shall act upon the application within a reasonable period of time.

9. The joint venture agreement

1) The joint venture agreement shall be the instrument of formation of a joint venture.

2) The joint venture agreement shall, among other things, contain the following:
a) the names, nationality, addresses and contributions of the shareholders of the joint venture;
b) the purposes for which the joint venture is formed;
c) the name and head office of the joint venture;
d) the par value and number of the shares;
e) the amount of the share capital and the value of the contribution in kind;
f) the period of time for which the joint venture is formed;
g) the manner of distributing profits;
h) the names of the chairman and the members of the Board of Directors;
i) the scope and duration of the tax exemption indicated in Article 27(2) of this proclamation;
j) the date of commencement of operation;
k) the frequency and method of calling, the quorum required and the voting procedures of the shareholders' meetings.

10. Registration

1) No joint venture may undertake activities hereunder unless it is registered with the Ministry of Domestic Trade.

2) An application for the registration of a joint venture shall be made to the Ministry of Domestic Trade in such form as shall be prescribed by the same Ministry.

3) The joint venture agreement and other documents as may be necessary as well as a letter issued by the Supreme Council endorsing the joint venture agreement shall be submitted together with the application for registration.

4) The Ministry of Domestic Trade shall issue a certificate of registration to a joint venture registered in accordance with this Proclamation.

5) Any changes in the particulars contained in the form of application and in the joint venture agreement made subsequent to registration shall also be registered.

11. Legal personality

A joint venture shall attain legal personality after Article 10 has been complied with.

12. Name of joint venture

1) A joint venture shall have a name which may indicate the nature of its undertaking.

2) The name of a joint venture shall not affect the rights of third parties.

13. Liability

1) A joint venture shall be liable only to the extent of its assets.

2) Shareholders of a joint venture shall be liable only to the extent of their shareholding.

CHAPTER THREE
TRANSFER OF SHARES AND SETTLEMENT OF DISPUTES

14. Transfer of shares

1) A foreign shareholder who wants to transfer his shares shall first make his offer to the Ethiopian shareholder to buy such shares.

2) Should the Ethiopian shareholder decline to buy the said shares or fail to respond to such offer within 90 (ninety) calendar days after receipt of the offer, the foreign shareholder may sell the said shares to any foreign natural or juridical person acceptable to all the shareholders.

3) The price of the share shall be mutually agreed upon.

15. Settlement of disputes

1) Any dispute arising from the joint venture agreement shall be amicably settled by the shareholders.

2) Failing settlement under sub-article 1, the dispute shall be submitted to arbitration.

3) Each party to the dispute shall nominate an arbitrator and the umpire shall be chosen by the arbitrators so nominated by each party provided, however, that where the arbitrators fail to agree on the choice of the umpire, he shall be chosen by the President of the International Chamber of Commerce.

4) The arbitral body constituted in accordance with sub-article 3 of this Article shall lay down its own rules of procedure.

5) The arbitral body shall apply the law or laws of Ethiopia relevant to the issue involved and shall ensure that the dispute is settled expeditiously.

6) The arbitral body shall also decide on the costs of arbitration and shall determine who shall bear such costs.

7) The awards of the arbitral body shall be final and conclusive.

CHAPTER FOUR
MANAGEMENT OF JOINT VENTURES

16. Shareholders' meeting

The shareholders' meeting shall be the highest body of any joint venture.

17. Powers and duties of shareholders' meeting

In addition to its powers and duties provided for in the joint venture agreement and in the other provisions of this Proclamation, the shareholders' meeting shall:

1) appoint the members of the Board of Directors;

2) appoint and define the duties of external auditors;

3) approve the accounts of the joint venture and reports of the external auditors;

4) approve the work programmes and budget of the joint ventures;

5) subject to Article 31 of this proclamation:
a) dissolve the joint venture and appoint liquidators;
b) amend the joint ventures agreement.

18. The Board of Directors

1) The Board of Directors of the joint venture shall be composed of such number of directors as may be agreed upon in the joint venture agreement provided that such membership shall be on the basis of shareholding in the joint venture.

2) The Board of Directors shall elect a chairman from among its members where no chairman has been elected by the shareholders.

19. Powers and duties of the Board of Directors

In addition to its powers and duties provided in the joint venture agreement and in the other provisions of this proclamation, the Board of Directors shall:

1) present to the shareholders' meeting draft policy and work programme of the joint venture for approval;

2) approve the loans and credits of the joint venture;

3) prepare and submit to the shareholders' meeting the budget of the joint venture for approval;

4) establish branches of the joint venture;

5) approve the appointment and dis-

missal of department heads and agents of the joint venture and define their responsibilities;

6) approve the internal regulations of the joint venture;

7) approve the sale of fixed assets of the joint venture;

8) prescribe its own rules of procedure;

9) delegate some of its powers to any member of the Board or to the General Manager of the joint venture;

10) Discharge such other duties as are assigned to it by the shareholders' meeting.

20. The General Manager

1) The General Manager and the deputy General Manager of the joint venture shall be appointed by the Board of Directors in accordance with the provisions of the joint venture agreement.

2) If the General Manager of the joint venture is not an Ethiopian national, the post of Deputy General Manager shall be filled by an Ethiopian national.

3) The General Manager shall be the chief executive of the joint venture and, subject to the general direction and supervision of the Board of Directors shall:
a) represent the joint venture with third parties;
b) prepare and, upon approval, implement the budget, plans and work programmes of the joint venture;
c) borrow money with the approval of the Board;
d) prepare the annual and other reports of the joint venture;
e) open and operate bank accounts in the name of the joint venture;
f) employ and dismiss employees in accordance with the internal regulations of the joint venture and the applicable law;
g) discharge such other duties as may be given to him by the Board of Directors.

4) The functions of the deputy General Manager shall be fixed in the joint venture agreement.

21. Employment of expatriates

Joint ventures may employ foreign nationals in accordance with the Ethiopian labour law in cases where qualified Ethiopian nationals are unavailable.

CHAPTER FIVE
ACCOUNT AND AUDITING

22. Books of accounts

A joint venture shall keep such books of accounts as are necessary in accordance with generally accepted accounting principles and practices.

23. Depreciation allowance

The depreciation allowance for fixed assets of the joint venture shall be in accordance with the relevant Ethiopian law.

24. General reserve fund

1) 5% of each year's net profits of the joint venture shall be set aside as reserve until such time as the said sum reaches 20% of the share capital of the joint venture.

2) The shareholders' meeting may establish other reserves.

25. Distribution of profits

Profits from the activities of the joint venture may be distributed to the shareholders only after transfers to the reserve funds have been deducted pursuant to Article 24 hereof.

26. Appointment of auditors

The external auditor(s) of the joint venture shall be appointed annually by the shareholders' meeting.

CHAPTER SIX
PRIVILEGES

27. Exemption

1) A joint venture shall be exempt from the payment of customs duties, government and municipal taxes levied on imports with respect to investment goods, and the first round of spare parts thereof which are required for the operation, production and processing of goods and services.

2) A joint venture may be granted total or partial exemption for the period to be specified in the joint venture agreement, from the payment of customs duties, government and municipal taxes levied on imports, with respect to raw materials and other materials which are required for the operations, production and processing of goods and services.

3) A joint venture may also be exempted from the payment of customs duties and transaction taxes levied on goods exported.

4) A joint venture shall be exempted from the payment of income tax:
a) for a period of 5 years in the case of new projects; and
b) for a period of 3 years in the case of major extension of existing projects and to the extent of such extension as from the day of commencement of production or operation.

5) A joint venture shall pay income tax on its taxable income at the rate of forty percent (40%).

6) Any dividend received from a joint venture which is reinvested in Ethiopia shall be exempt from the payment of income tax.

7. The salaries and allowances of expatriate employees of a joint venture shall be exempt from income tax.

28. Remittance

1) Any dividend remitted abroad shall be taxed at the rate of 10% of the amount remitted.

2) Any foreign shareholder may remit proceeds from liquidation of the joint venture.

3) Any foreign shareholder whose shares are purchased pursuant to Article 5(4) hereof, shall be entitled to repatriate the full amount of the purchase price he receives.

4) Expatriate employees of the joint venture may remit their savings in accordance with the foreign exchange regulations of Ethiopia.

29. Foreign currency

A joint venture may open foreign currency accounts in accordance with the foreign exchange regulations of Ethiopia.

CHAPTER SEVEN
MISCELLANEOUS PROVISIONS

30. Dissolution and winding-up

1) A joint venture may be dissolved for any one of the following reasons:
a) expiry of the life of the joint venture fixed in the joint venture agreement;
b) dissolution resolved by a meeting of the shareholders;
c) institution of bankruptcy proceeding;
d) loss of three-quarters of the capital.

2) Subject to sub-article 1 of this Article, the provisions of the Commercial Code of Ethiopia relating to the dissolution and winding up of share companies including the provisions on bankruptcy shall apply, mutatis mutandis, to joint ventures.

31. Special majority required

No decision to dissolve a joint venture or to amend a joint venture agreement shall be taken unless shareholders representing at least 75% of the shares have voted in favour of such dissolution or amendment, as the case may be.

32. Procedures of procurement and marketing

1) A joint venture shall, whenever possible, give preference to domestic materials, products and services.

2) The parties to a joint venture shall determine in the joint venture agreement the manner of:
a) procuring raw material required for the activities of the joint venture; and
b) marketing the products of the joint venture.

3) Notwithstanding any other law to the contrary, the joint venture may procure raw materials and market its products as agreed upon in the joint venture agreement.

33. Existing arrangements

Nothing in this Proclamation shall be construed as modifying arrangements entered into by the Ethiopian Government with other states or public or private organizations or individuals concerning joint venture.

34. Issues not covered by this law

The relevant Ethiopian law shall apply to matters that are not covered by this Proclamation.

35. Conflict with other laws

1) Subject to sub-article 2 of this Article, no law which is inconsistent with this Proclamation shall have force or effect in respect of matters provided for herein.

2) Special legislation may be promulgated governing the prospecting, exploration and exploitation of petroleum and other minerals. Under special circumstances or pending such promulgation, the Council of Ministers may approve special agreements for prospecting, exploration and exploitation of petroleum and other minerals.

36. Implementation of this Proclamation

The Supreme Council shall be responsible for the implementation of this Proclamation.

37. Power to issue regulations

The Supreme Council may issue regulations for the better carrying out of this Proclamation.

38. Effective date

This Proclamation shall enter into force on the date of its publication in the Negarit Gazeta.

Done at Addis Ababa, this 22nd day of January 1983.

The Provisional Military Administrative Council.

Remittance of Profits and Capital

1. JOINT VENTURE LEGISLATION

Through its new joint venture legislation the Ethiopian Government has tried to create a new modus for foreign investment, which it recognises to be of great importance for the achievement of national development objectives. For every foreign investor it is important, not only that the investment yields profits but also that he can enjoy these profits. Therefore profits, made by the joint venture, should be distributable and that part that accrues to the foreign investor as well as the initial investment, should be freely remittable.

The Joint Venture Proclamation*, which entered into force on 22 January 1983, creates the possibility for aliens to have a minority participation (maximum 49%) in a joint venture with Ethiopian capital (Art. 4(3)) in various sectors of the economy (Art. 3(2) excludes certain sectors). The initial capital contribution can be made in cash or in kind. If the alien makes a cash contribution it must be in freely convertible currency (Art. 6).

Once the project is generating profits, **distribution** of these profits can take place freely and in accordance with the wishes of the parties as previously expressed in the joint venture agreement (Art. 9(2) g). One limitation however provides that 55% of each year's net profits must be set aside as reserve until such time as the reserve sum reaches 20% of the share capital (Arts. 24 and 25).

As far as **remittance** of dividends and capital is concerned the Joint Venture Declaration only provides for free repatriation of proceeds resulting from the liquidation of the venture or from compulsory sale of the shares to the government for reasons of national interest (Art. 28(2) and (3)). To all other cases the normal foreign exchange regulations of Ethiopia apply (Arts. 28(4), 29 and 34).

2. FOREIGN EXCHANGE REGULATIONS

Art. 42 of the 1976 Monetary and Banking Proclamation* authorises the National Bank of Ethiopia to issue directives relating to gold and foreign exchange transactions. In notice 1/1977, containing the Foreign Exchange Regulations*, the Bank has issued a rather restrictive set of rules.

- All imports and exports are subject to previous authorisation: importers must apply for necessary foreign exchange and exporters must undertake to surrender the earned foreign exchange to the Bank or to an authorized bank (Arts. 19, 48 and 49).
- Chapter IV of said Regulations, relating to capital remittances by foreign investors, makes a distinction between recognised and not recognised investments. It is provided that in case of selling or liquidating a not-recognised investment, foreign exchange remittance can take place at the moment of final departure (Art. 33). However, remittance is subject to previous approval and to an annual maximum of 40,000 Birr. Funds in excess of this maximum are to be deposited in a blocked account (Art. 35). By Amendment of 17 May 1978* the annual limit was reduced to 20,000 Birr.
  In the case of a recognised investment, remittance of initial investment and reinvested profits apparently can take place after application for an exchange control permit (Art. 34). It is not clear whether the Exchange Authorities have a discretion in granting or refusing this permit.
- Transfer of funds without the necessity of obtaining an exchange control permit is possible through special accounts (non-resident transferable Birr account, non-resident foreign currency account) which are, however, only available to special categories of persons (non-residents, residents who qualify for remittance, non-resident nationals) and organisations (Embassies, UN, OAS), (Art. 88).

3. SPECIAL EXCHANGE REGULATIONS FOR JOINT VENTURES

In September 1983 the National Bank of Ethiopia issued amendments to the foreign exchange regulations*, providing for a more liberal regime for joint ventures established in accordance with the 1983 Proclamation. First of all the limit on the annual remittable sum of 20,000 Birr, does not apply to joint ventures established under the Proclamation.

Secondly, a joint venture may be permitted to open a foreign currency transferable or non-transferable Birr account for the purchase of raw materials, equipment and spare parts not available in the local market and the manner of procurement of which has been determined in accordance with the joint venture agreement.

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* We would like to express our gratitude to Prof. Dr. Seyoum Haregot, Professor of Public Finance Law at Addis Ababa University and Rapporteur for the International Bureau of Fiscal Documentation, who provided us with the necessary documents including:
- Proclamation No. 235 of 1983, Joint Venture Establishment Proclamation, Negarit Gazeta, 42nd Year No. 6 of 22 January 1983, at 22.
- Proclamation No. 99 of 1976, Monetary and Banking Proclamation, Negarit Gazeta, 36th year No. 1 of 21 September 1976, at 1.
- National Bank of Ethiopia, Notice No. 1/1977, Foreign Exchange Regulations of 5 January 1977.
- National Bank of Ethiopia, Amendment to Notice 1/1977 of 17 May 1978.
- National Bank of Ethiopia, Amendment to Notice 1/1977 of 2 September 1983.

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1984 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Africa

ONOH, J.K.
Money and banking in Africa.
Harlow, Longman Group Ltd. [Longman House, Burnt Mill, Harlow, Essex], 1982. 214 pp.
Textbook with emphasis on the areas of money, banking and international finance of African countries covering Anglophone, Francophone, Portuguese and Arab speaking Africa.
(B. 13.176)

Gabon

TRAITE DE FISCALITE GABONAISE
Libreville, FIDAFRICA [B.P. 2164], 1983. 142 pp.
Loose-leaf publication describing the taxes levied in Gabon. Investment law and income tax treaty between Gabon and France and other international agreements are also dealt with, i.e. U.D.E.A.C. (la Convention fiscale de l'Union Douanière et Economique de l'Afrique Centrale of December 13, 1966).
(B. 13.177)

Kenya

THE KENYA BUDGET 1983.
Client Information Bulletin 1/83.
Nairobi, Price Waterhouse, 1983. 3 pp.
Summary of the tax changes proposed in the Finance Bill 1983 as outlined in the Budget Speech presented on 23 June 1983.
(L. 11.340)

Morocco

BENSALAH ZEMBANI, Anas.
La fiscalité face au développement économique et social du Maroc.
Paris, Librairie Générale de Droit et de Jurisprudence [20 Rue Soufflot, 75005 Paris], 1982. 395 pp.
Study describing the taxation towards the economic and social development in Morocco.
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UNITED STATES:

The Apportionment of Multistate and Multinational Corporate Income for Tax Purposes

By Johnny C. Finch

Mr. Johnny C. Finch is Associate Director, General Government Division, United States General Accounting Office. This paper was delivered before the Task Force of the President's Worldwide Unitary Tax Working Group on 15 November 1983.

We are pleased to be here to assist the task force in its work concerning the issues surrounding the apportionment of income for tax purposes. The GAO originally became involved with the issues at the request of the House Ways and Means Committee. The Committee was interested in the Federal and State problems resulting from U.S.-based corporations operating in a multistate and multinational environment and from foreign multinational corporations operating in the United States.

At the Federal level, the Committee wanted to know how the IRS applies Sec. 482 of the Internal Revenue Code to correct what it determines to be unjustified allocations of income among commonly controlled corporations. Specifically, the Committee was interested in finding out whether the IRS was experiencing difficulty in administering Sec. 482 and, if so, whether the cause was poor management, a flawed conceptual approach, or a combination of both.

At the State level, the Committee was concerned about variations in the use of formulas to determine the amount of taxable income that multijurisdictional corporations derive within a State. Because of this concern, the Committee asked the GAO to develop information on how the States apportion income and the feasibility of all States using the same method.

We approached our work on the Federal and State issues concurrently. Although we issued two reports – one in September 1981 on the IRS' administration of Sec. 482[1] and the other in July 1982 on State taxation of multijurisdictional corporate income[2] – the reports are related in that they discuss alternative approaches to the same basic question of how to divide corporate income among jurisdictions for tax purposes.

Therefore, the thrust of our presentation today, as requested by the task force, will focus primarily on our findings regarding the IRS' application of Sec. 482 of the Internal Revenue Code, but we will also briefly discuss our findings regarding State taxation of multijurisdictional corporate income where we think those findings are relevant to the issues the task force is considering.

Section 482 of the U.S. Internal Revenue Code:

Allocation of Income and Deductions among Taxpayers

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Scope of GAO's review of IRS' administration of Sec. 482

I would like to begin my discussion of our report on Sec. 482 by outlining the scope of our review. Basically, we studied the IRS' administration of Sec. 482 by reviewing the results of its examination of large multinational corporations included in its Coordinated Examination Program (CEP). At the time of our review, each of the 637 corporations included in this program had assets of $250 million or more. Generally, the IRS examines the returns of these corporations for each tax year.

1. "IRS Could Better Protect U.S. Tax Interests In Determining The Income Of Multinational Corporations" (GAO/GGD-81-81, 30 September 1981).
2. "Key Issues Affecting State Taxation Of Multijurisdictional Corporate Income Need Resolving" (GAO/GGD-82-38, 1 July 1982).

We used multinational corporations in the CEP because at the time we did our work:

- they accounted for about 90% of the dollar volume of transactions between all U.S. parents and foreign subsidiaries, and
- they accounted for about 70% of the IRS' total effort in examining international tax issues.

We asked the IRS to provide us with international examiners' reports and selected sections from revenue agents' reports prepared on examinations of the 637 multinational corporations. The international examiners' report is usually completed first and information from it is then incorporated in the revenue agent's report. We ultimately received one or both reports on 519 of the 637 corporations.

The statistics we developed from the reports received for the 519 corporations showed that the IRS recommended 403 Sec. 482 adjustments totalling $277.5 million. These adjustments involved 200 parent corporations and their foreign subsidiaries. We did not develop statistics on the Sec. 482 adjustments the IRS made to transactions between the 519 corporations and Western Hemisphere Trade Corporations (WHTCs), Domestic International Sales Corporations (DISCs) and/or U.S. possession corporations. These adjustments totaled $330 million and involved 235 corporations. We excluded these adjustments because the transactions did not involve a foreign subsidiary and, therefore, did not in a real sense cross national boundaries. DISCs are corporations located in the United States which primarily perform a sales function. We had been told by some examiners that difficulties associated with making adjustments involving foreign subsidiaries are not always encountered when adjusting the income between a DISC and its U.S. parent. In addition, WHTCs have been phased out. A review of adjustments involving these corporations would not have been a valid test to indicate how effective the arm's length standard may be in adjusting the income of other corporations in future years.

Thus, we focused our work on transactions that involved foreign subsidiaries because it is in this area that the real workability of the arm's length standard must be measured and the area where arm's length must work well, if it is to be effective. This area has grown rapidly since World War II and will probably continue to grow as multinational corporations expand their markets in foreign countries.

In addition to developing statistics on the nature and extent of adjustments made by the IRS in enforcing Sec. 482 for the corporations in our sample, we also developed statistics, through a review of the examination reports, on the pricing method used by the IRS examiners in making the adjustments. The reports either stated the method the examiner had used or the method used was obvious, based on the examiner's description of what had been done. In the case of 25 adjustments, however, we were unable to determine the method used from information in the reports.

We also examined IRS policies, procedures, and practices for enforcing Sec. 482; reviewed studies and papers prepared by recognized authorities; and interviewed numerous IRS and Treasury officials.

I would now like to discuss the findings, conclusions, and recommendations in the Sec. 482 report.

IRS' procedures for administering Code Sec. 482

The first major section in our report deals with the IRS' procedures for enforcing Sec. 482. In this section we identified problems and recommended improvements. We recommended that Congress amend the Internal Revenue Code to provide better information reporting by foreign-controlled corporations; that Treasury make necessary adjustments in the safe haven interest rate; and that the IRS implement specific improvements, including (1) making better use of management information, (2) requiring the participation of economists in certain Sec. 482 adjustments, (3) requiring economists to communicate useful information to other IRS audit teams, and (4) revising the form used by corporations to report information concerning the sale and purchase of stock in trade and intercorporate loan transactions.

Congress responded to our legislative recommendation by including a provision in the Tax Equity and Fiscal Responsibility Act of 1982 to require foreign-controlled corporations operating in the United States to disclose dealings with foreign affiliates. The Treasury has taken action concerning our recommendation to make necessary adjustments in the safe haven interest rate. And the IRS has either made improvements or is making improvements in its Sec. 482 enforcement procedures in response to our recommendations.

How can Sec. 482 enforcement be made more certain and less administratively burdensome?

The second major part of our report deals with the question of how Sec. 482 enforcement can be made more certain and less administratively burdensome. Since I would expect that the issues covered in this part of our report are of greatest interest to the task force, I would like to concentrate on them.

We found that adjusting multinational intercorporate transactions for tax purposes under current Sec. 482 regulations is administratively burdensome for both the IRS and the corporate taxpayer. Moreover, the considerable amount of judgment necessary in most income adjustments recommended under the regulations creates uncertainty. In recent years, the regulations have been a source of dissatisfaction to all parties affected, including the courts.

In essence, many critics of Sec. 482 enforcement hold that the theory on which it rests no longer corresponds to the realities of intercorporate transactions. In theory, a Sec. 482 adjustment should be made when income reported for a multinational intercorporate transaction varies from the comparable uncontrolled price or, in other words, an arm's length price of a similar transaction between two unrelated businesses. In practice, however, IRS examiners have difficulty finding a comparable uncontrolled price for most transactions. Of the examinations we reviewed, only 3% (12 of 403) of the IRS' recommended adjustments between parents and foreign subsidiaries were based on comparable uncontrolled prices. The income adjusted through these arm's length prices amounted to only 3% of the total income adjusted for Sec. 482 issues.

The regulations provide some guidance for those instances where an arm's length price cannot be identified; but, too frequently, the examiner must use considerable judgment in analyzing extensive data which often does not directly relate to the specific situation at hand. To the extent that the facts do not directly relate, the adjustment price becomes an estimate.

IRS makes relatively few adjustments on the basis of comparable independent prices

The Treasury issued regulations in 1968 which provided the IRS with guidelines for making Sec. 482 income adjustments. The regulations explain the arm's length standard, the principle underlying Sec. 482 adjustments, as follows:

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer . . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

For example, uncontrolled transactions with respect to the transfer of tangible property are defined as:

- sales by a member of the controlled group to unrelated businesses,
- sales to a member of the controlled group by unrelated businesses, and
- sales in which the businesses are not members of the controlled group and are not related to each other.

The IRS first tries to identify independent transactions which are exactly comparable or nearly identical to the transaction in question. In the absence of such independent transactions, the regulations permit the IRS to use other alternative techniques to apply the arm's length standard. The alternative techniques generally involve constructing adjustment prices based on independent transactions that fall short of being exactly comparable or nearly identical to the transaction in question. The regulations provide guidelines for making adjustments to the following 5 categories of intercorporate transactions: (1) sale of tangible property, (2) transfer or use of intangible property, (3) loans and advances, (4) performance of services, and (5) use of tangible property (rent). The regulations permit the use of alternative techniques for adjustments in all 5 categories of transactions when a comparable uncontrolled price cannot be found. The regulations also require the use of safe haven rules under certain conditions for transactions involving loans and advances, performance of services, and the payment of rent.

Our study showed that few Sec. 482 adjustments are made using prices based on comparable uncontrolled transactions. As I mentioned previously, only 3% of the 403 IRS recommended Sec. 482 adjustments were based on arm's length prices determined through comparable uncontrolled transactions. The 403 adjustments involved 200 of the 519 multinational corporations in our data base and their controlled foreign corporations.

Our analysis also showed that 26% of the Sec. 482 adjustments were made using alternative techniques. These require a great degree of subjective judgment by the examiner. The income adjusted through alternative techniques amounted to 65% of the total adjusted. The tax impact of these adjustments is not known precisely but can be roughly estimated at $87 million based on a corporate tax rate of 48%.

I will now describe the kinds of alternative techniques available to IRS examiners by citing our analysis of income adjustments for tangible property. The IRS considers tangible property adjustments to be the most important of the 5 categories discussed in the regulations because the largest amounts of revenue are involved. Tangible property adjustments in our data base amounted to 45% ($125.1 of $277.5 million) of the total income adjusted by the IRS under Sec. 482.

When a comparable uncontrolled price for a tangible property adjustment cannot be identified, the regulations direct examiners to first apply the resale price method, then the cost plus method, and finally a fourth method defined as "some appropriate method". These methods must be applied in sequence until an appropriate basis for an adjustment is found.

Our statistics show that the IRS was able to identify prices established through comparable uncontrolled transactions in only 15% (5 of 34) of its tangible property adjustments. Even more revealing is that the adjustment amounts based on comparable uncontrolled transactions represented only about 2% ($2.3 of $124.2 million) of the tangible property income which was adjusted by the IRS through determinable methods.

Information in the reports the IRS provided us was not sufficient to determine the pricing method used for 3 of the 37 tangible property adjustments. However, only 5 of the remaining 34 adjustments were made using prices obtained from comparable uncontrolled transactions. When comparable uncontrolled transactions could not be identified, IRS examiners most often used the fourth or "any other" method. Thus, 86% of the income adjustments resulting from the sale of tangible property were made using the method for which the regulations provide the least guidance.

As shown in our report, our detailed analysis of adjustments involving the other 4 categories of intercorporate transactions – that is intangible property, loans and advances, services, and rent – also demonstrated that few of those adjustments were based on comparable uncontrolled transactions.

Potential adjustments may be missed under current Sec. 482 regulations

The administrative complexity produced by the current Sec. 482 regulations may result in potential adjustments not being made. The regulations prescribe a complex and time-consuming process for making adjustments. First, the examiner must identify questionable transactions. If safe haven rules do not apply, the examiner must perform a functional analysis of the transactions, search for comparable uncontrolled prices which are rarely obtainable, and then construct comparable uncontrolled prices using judgment to the degree needed. Because examiners work on several cases simultaneously, precise data on the average time required for a Sec. 482 adjustment is lacking. However, our interviews with IRS examiners and the statistics we developed indicate that the IRS' limited number of examiners are unable to cover the universe of multinational intercorporate transactions. Thus, given the complexity of the current regulations and the IRS' limited resources with which to implement them, there is a need for revised guidelines which could be more easily administered and which would bring greater certainty and less burden to Sec. 482 enforcement.

To enforce Sec. 482 under the arm's length standard, the IRS must examine in detail the particulars of intercorporate transactions. Because of the large number involved, the IRS cannot possibly do this for all transactions between corporations and related foreign subsidiaries. For example, the 519 multinational corporations in our data base generated $32 billion in sales with about 12,000 foreign subsidiaries. Thus, the first step of the IRS' enforcement process is the decision as to which transactions are to be reviewed in detail during the examination.

Once questionable transactions have been identified, examiners must begin the proces of determining if an adjustment is needed and, if so, the amount. Where safe haven rules cannot be applied, examiners must obtain detailed information concerning the transactions in question. To determine whether the intercorporate transactions were priced at arm's length, examiners must usually perform a functional analysis. This involves a probe into exactly what the parent and its subsidiary actually did in relation to the income earned. A functional analysis is required because the IRS believes that facts regarding comparable transactions must be analyzed to determine with accuracy just what should be measured.

According to the IRS manual, a functional analysis is based on the economic principle that in a business enterprise, or a group of enterprises, each function should earn its fair share of any resulting profits. When various functions are performed, the enterprise that provides most of the effort, and/or the rare or unique functions, should earn most of the profit. The IRS measures the relative importance of each function through functional analysis. The IRS manual requires the examiner to obtain sufficient data to answer questions such as: What was done? What significant functions were involved in doing it? Who performed each function? And, what was the economic value of each function performed by each party? The manual specifies that normally the functional analysis begins with the organization which initiated the transaction and carries through until the transaction generated income from outside the controlled group.

Once the significant functions and who performed them have been identified, the functions themselves must be analyzed. This analysis requires that examiners obtain other information to answer questions such as: Could anyone else perform the functions? How difficult are they? What skills are required? And, what equipment is used? According to the IRS, it is critical that examiners focus on the relative importance of each function in terms of contribution to the total profit picture. Thus, a functional analysis requires data which may take considerable time to obtain and an analysis which will take still more time.

Once an examiner has completed a functional analysis, the next step is to search for a comparable uncontrolled price. The IRS manual requires the examiner to begin by investigating the validity of the method used by the corporation in arriving at the price it used. For example, if the commission charged to a foreign corporation was based on commissions charged to independent parties, the independent transactions should be examined to determine if the commission can be used as a comparable. When a comparable price cannot be found from within the corporation's own controlled group, the examiner must look to third party data. This step would require obtaining appropriate information from Government sources, industrial organizations, investment services, and the private business sector.

Regardless of where comparables are obtained, the examiner must develop sufficient information concerning them to show that the transactions used are in fact comparable. This requires details concerning the terms at which the comparable transactions were handled and the circumstances surrounding the transactions, including a comparison between (1) functions performed by each party involved in the comparable transaction and (2) functions performed by the parent and foreign subsidiary in the questioned transaction.

The IRS considers third party transactions comparable to the controlled transactions if the property and circumstances in the uncontrolled transactions are identical to those in the controlled transaction; or if they are so nearly identical that they have no effect on price or can be reflected by a reasonable number of adjustments to the uncontrolled sales. The IRS also instructs its examiners that in some cases a single "best" comparable may not be found. Instead, there may be several independent transactions each of which differs from the questionable transaction in some significant way. However, considered together, the several independent transactions may be used to determine an arm's length price for the questionable transaction within a usable narrow range.

In talking with examiners in the 7 IRS districts included in our review, we learned that they believe that some potential Sec. 482 adjustments are not being developed. Examiners in 3 districts attributed this situation to both the difficulties in the enforcement process and the time it takes to do the work. They stated that some examiners give higher priority to other international tax issues, such as foreign tax credits, because it is less difficult and less time-comsuming to identify the additional tax. They added that Sec. 482 work is a "high risk venture" where much audit work can result in little additional tax. They pointed out that because of this, some examiners hesitate to "go out on a limb" in attempting to develop an adjustment and focus only on cases of flagrant abuse. The examiners indicated that a Sec. 482 adjustment might not be attempted because of the difficulty involved in reaching agreement on an arm's length price or on the basis for making the adjustment.

The IRS was unable to provide us with data on the average length of time required to identify and develop a Sec. 482 adjustment. One reason for this is that examiners work other international tax issues at the same time they are developing Sec. 482 adjustments and sometimes work on several examinations simultaneously. Examiners also pointed out that the time needed to develop an adjustment can vary greatly depending on the type of adjustment being developed, the pricing method which must be used, and the cooperation of corporate officials.

A few examiners explained why the enforcement process takes so long. The primary reasons, according to the examiners, are that it takes time to study the corporation and/or its industry to become sufficiently knowledgeable to perform a functional analysis and to analyze comparable transactions, and that it takes time to obtain the substantial data and records that are needed from the corporation and other sources.

IRS examiners have also stated that they are unable to cover the universe of potential adjustments. During interviews in 1977 with the House Committee on Ways and Means Oversight Subcommittee staff, IRS examiners said that when they are faced with numerous records of transactions, they generally rely on either a scanning of the records or the examination of a few of the largest dollar transactions over a one or two-month period. It is obvious that with such techniques only a few transactions can be examined and that if transactions are not examined, potential adjustments cannot be identified.

Our statistics can be interpreted to lend credence to the examiners' comments. For example:

- Only 200 of the 519 multinational corporations in our data base had Sec. 482 adjustments involving their foreign subsidiaries.
- The total profit before taxes of the corporations examined was \$43.5 billion. However, the adjustments amounted to only \$277.5 million, a relatively small impact on corporate profit. The adjustments increased the profit of U.S. parents by 0.9% and reduced the profit of foreign subsidiaries by 2.4%.
- The bulk of the total \$277.5 million was concentrated in only a few of the 403 total adjustments. Eleven of the 403 adjustments accounted for over one half of the \$277.5 million.
- Adjustments involving the sale of tangible property, the category of intercorporate transaction where the largest amounts of revenue are at issue, were also concentrated. Thirty-five U.S. parents and 89 of their foreign subsidiaries experienced adjustments on tangible property sales of \$4.4 billion. The other 12,248 foreign subsidiaries of the 519 U.S. parents experienced no adjustments to a total of \$28.1 billion in intercorporate sales transactions.

Neither we nor the IRS know how much non-compliance exists, nor how many more adjustments the IRS should have made. However, given the difficulty inherent in administering Sec. 482 through the current Treasury regulations, the examiners' statements, and the statistics on the adjustments the IRS made, we believe it is reasonable to conclude that the potential for greater enforcement exists.

The difficulty in making Sec. 482 adjustments and the impact this difficulty has on enforcement was recognized as early as 1962 in a House report. The report stated that, in practice, the difficulty in determining a fair price under this code provision severely limits the usefulness of its power, especially when there are thousands of different transactions between a domestic corporation and its foreign subsidiaries.

A more recent study documents the fact that Sec. 482 adjustments continue to be a problem. The study, issued in January 1981, at the request of the Acting Commissioner of the IRS, the Assistant Attorney General, and the Assistant Secretary of the Treasury for Tax Policy, concluded that Sec. 482 is one of the most important tools available to the IRS for dealing with tax haven transactions but that both the IRS and taxpayers have had difficulties with the current Sec. 482 regulations. The study recommended that the regulations be amended so as to ease some of the administrative burdens placed on both taxpayers and the IRS and to achieve greater certainty in pricing international transactions.

IRS and Treasury have considered changing the Sec. 482 regulations

As documented in our report, representatives of all groups affected by and knowledgeable about Sec. 482 enforcement under the arm's length standard have voiced continuous and substantive criticism of the regulations. The criticisms focus on the fact that Sec. 482 enforcement creates a large administrative burden and that the end result of Sec. 482 enforcement actions is too often unpredictable and subjective.

During 1971, the Treasury and the IRS considered, but did not implement, several regulation changes involving the sale of tangible property transactions. The changes were considered to make Sec. 482 enforcement using the arm's length standard fairer and less difficult. According to a Deputy Assistant Secretary of the Treasury, consideration of the changes was needed because of persistent criticism of the regulations by corporate officials, professional groups, corporate associations, and trends in court cases. The proposed changes were circulated to the Treasury, the IRS, and the Department of Justice for comment; but no action was taken. The proposed changes included:

- Reducing uncertainties encountered by multinational corporations in determining whether an intercorporate transaction would be subject to an adjustment by revising the regulations to extend the use of safe haven pricing.

- Revising the priorities given to various methods of determining an arm's length price. Specifically, only prices actually obtained from comparable uncontrolled transactions involving the corporation in question would be given priority. The search for an arm's length price would thus be limited to within the corporation.
- Specifying in the regulations how the examiner should arrive at an arm's length price when using the fourth ("any other") method.

A 1978 closing memorandum noted that several of the comments received on the proposed changes indicated that large businesses es would benefit while small businesses would be adversely affected. Other comments indicated an overall satisfaction with the existing regulations. The IRS' Economic Advisory Group commented that the proposed changes would condone the non-arm's length pricing of intercorporate transactions and significantly reduce the revenue the IRS achieves from Sec. 482 enforcement. Apparently for these reasons, no further action was taken.

Treasury should study the feasibility of improving the Sec. 482 regulations

The regulation changes considered by the Treasury and the IRS were drafted in 1971. Since then, experts in the field of Sec. 482 enforcement, independent studies, court opinions, and corporate officials have continued to express substantive criticisms of the uncertainty and administrative burden created by the Sec. 482 regulations. The validity of the arm's length premise has been questioned and specific changes to the regulations have been suggested.

We believe the problems experienced in implementing the Sec. 482 regulations are sufficiently serious to be addressed. To do this, we recommended in our report that the IRS Treasury should, as a first step, undertake a study to identify and evaluate the feasibility of the suggested changes to Sec. 482 as well as to identify additional ways to allocate income. To our knowledge, Treasury has not undertaken such a study.

Corporate officials and experts have suggested ways to make Sec. 482 adjustments more certain

Some corporate officials have suggested changes to the regulations which would provide greater certainty before an IRS examination and would thus allow them to better plan their financial strategy. The suggestion offered most frequently by corporate officials was that the Treasury identify some means of establishing a range of prices within which U.S. corporations could operate without fear of later adjustments. Some executives have suggested that safe haven ranges be worked out on an industry or product-line basis. Others have suggested that some division of profit between the U.S. corporation and its foreign subsidiaries be set as a reasonable yardstick. In either case, the officials believed the safe haven range would eliminate the uncertainty concerning the pricing of intercorporate transactions and reduce unproductive administrative costs to both the corporations and IRS. Underlying the comments of many officials who favored a safe haven range for pricing is the conviction that such a range, however difficult to establish, would be an improvement over the present system of determining arm's length prices. The expanded use of safe havens would allow corporate officials a degree of certainty they now lack as to the tax consequences of their pricing of intercorporate transactions. Those corporations whose market situation required pricing structures that fell outside the safe haven range would be no worse off than they are today. They would still have to bear the burden of proving that their prices were justified.

Tax experts, in articles based on court cases, studies, and other sources of information, have also stated that regulation changes are needed. Their suggestions have generally revolved around the use of save havens and profit splits as acceptable methods to use in determining Sec. 482 income allocations. For example, corporate officials suggested in one study that the Treasury expand the use of safe haven rules, establish acceptable profit splits or a minimum percentage of the profit to be included in U.S. income, and adopt formulas such as those available to DISCs for calculating transfer prices.

In connection with the above comments, the IRS has established centralized pricing units for a few commodities. These units control the price that must be used by internal examiners in making Sec. 482 adjustments. The price established by the pricing units is known by both corporate officials and IRS examiners. According to the IRS, the pricing units were established to better use limited resources and to provide for uniform and consistent treatment of common issues among corporate taxpayers.

Formula apportionment – A possible alternative to the arm's length standard?

Now that I have discussed the IRS' administration of Sec. 482 and the arm's length approach to income apportionment, I would like to briefly discuss another approach – formula apportionment – which we described in our report on State taxation of multijurisdictional corporate income.

Some experts and studies have suggested using formula apportionment, where applicable, instead of the arm's length standard

Some experts and studies have questioned the validity of the premises underlying the arm's length standard that a parent corporation and its subsidiary are in all instances operating as two separate corporations. These experts and studies have argued that when a multinational parent's operations are sufficiently integrated with its foreign subsidiaries, formula apportionmment, as used by the States, is a more appropriate method to use in allocating the income. In these situations, they believe the arm's length standard is fundamentally flawed because it is not consistent with the economic reality of the operations of the related corporate group.

In contrast to the arm's length standard, formula apportionment under the unitary method views controlled corporations which conduct integrated business operations as a single unit or business for tax purposes. The premise is that these controlled corporations are coordinated by a central management policy and organizational structure which seeks to maximize profits. It is argued that since all of the controlled corporations which are involved in the integrated operations are considered to be part of the same unitary business, intercorporate transactions cannot produce a real economic gain or loss. Thus, profit or loss is determined solely by transactions with unrelated businesses, the same as for a "truly" independent corporation.

Under formula apportionment, a formula is used to apportion the income between the commonly controlled corporations. The formula represents the relationship of the individual corporation's activities to the total activities for the controlled group. The factors most discussed for use in the formula are the ones used by the States to tax multistate and multinational manufacturing and mercantile corporations. All 45 States which tax corporate income use some combination of property, payroll, and sales as formula factors. The apportioning of the income by such a formula is merely a device for the division of the income earned. The formula does not impose any tax on the income.

Formula apportionment might eliminate some problems associated with using the arm's length standard

Advocates of formula apportionment indicate that this method is not only more appropriate to use in situations involving integrated operations among controlled corporations but could actually eliminate some of the problems associated with using the arm's length standard. They explain that the States use formula apportionment primarily because of (1) the extensive potential for tax avoidance through non-arm's length transactions between controlled corporations, (2) the need to substantially increase the number of their auditors to address this potential through the arm's length standard, and (3) the belief that enforcement through the arm's length standard is not working well at the Federal level. They also point out that formula apportionment eliminates the arm's length assumptions that:

- an arm's length market price can always be established;
- general overhead and administrative expenses can be fairly allocated among the commonly controlled corporations involved in the integrated operations; and
- it is possible to determine the proper amount of profit allocation to different functions such as manufacturing and selling.

In addition, advocates claim formula apportionment would eliminate the complaints of multinational corporations (1) that they do not know at the time transactions take place whether they will result in an IRS allocation and (2) that they are operating under regulations characterized as vague, confusing, and impossible to interpret in terms of international business.

Formula apportionment would present different problems

One of the biggest objections to the use of formula apportionment, especially when it is applied to multinational corporate operations, is that it is difficult to define the corporate entities which should be included in the unitary group. State and corporate officials often do not agree on how to define a unitary business. Furthermore, the decisions of the courts on this question have often been vague and conflicting.

Formula apportionment can only be applied to a unitary business. In practice, however, deciding whether a business is unitary is a difficult task. The determination often involves analysis of complex corporate structures and operational relationships. Many modern multijurisdictional corporate entities consist of hundreds of divisions, branches, or subsidiaries whose relationship to one another and to the parent corporation are not readily clear. Identifying the elements to use in determining if such a corporate enterprise should be considered unitary for tax purposes is the crux of the problem. Moreover, even if States and corporate taxpayers could agree on the elements, reaching agreement on how the elements should be quantified would present further problems.

In simple terms, a unitary business can be defined as one in which there is a relationship of "dependency and contribution between the portions of the business within and without the taxing State". Several criteria have been used by the courts to define a unitary business, but the most common ones, developed by California courts and used by that State's tax administrators, consist of:

- unity of ownership as manifested by the percentage of voting stock owned;
- unity of use as evidenced by centralized performance or services, such as accounting, and advertising; and
- unity of operation and management as demonstrated by a centralized executive force and general system of operation.

Although these criteria and versions of them provide some guidance to States and corporations for determining if a business's operations are unitary, they have not been extensively used. According to one expert, the reason for their limited use may be due to the fact that no general conclusions can be reached based on the criteria. While each of the criteria used by the various courts purports to set forth an objective standard, the standards are so general that they are of limited help.

In part, because the unitary criteria applied are so general, corporations frequently protest a State's determinations that all or part of their business operations are unitary. Of the more than 600 large corporations in the sample we took for our State tax study which were required to use domestic combined reporting, about 40% filed protests in this regard. Most of these corporations filed protests in only one State, even though they were required to use domestic combined reporting in several States. The largest area of disagreement involved the determination of substantial interdependence in basic operating fuctions.

State and corporate tax officials generally disagree on the primary criteria for determining whether a business is unitary. Corporate tax officials believe that the primary criterion should be a "substantial interdependence" test – that is interdependence in basic operating functions, such as purchasing of raw materials and financing of customer receivables. For example, 80% of the large corporations and about 75% (7 of 9) of the CPA firms responding to a questionnaire we prepared said that the "substantial interdependence" test should be at least one of the criteria comprising the unitary business definition. On the other hand, State tax representatives generally believe that control, as manifested by stock ownership, should be the primary criterion.

Despite the disagreements in defining a unitary business, it might be possible to combine criteria to arrive at a definition. For example, it might be feasible to combine a stock ownership test with a substantial interdependence test to derive a standard which is acceptable to both State and corporate tax officials. In addition to obtaining acceptance of such criteria, however, another major obstacle would be reaching agreement on the percentages to apply. State officials we contacted, for instance, generally favored defining a unitary business as existing when one corporation owns more than 50% of the stock of another corporation. Conversely, corporate officials we contacted believed an 80% stock ownership figure should be required for defining a unitary business.

Similar differences could also arise concerning the percentages needed to substantiate the interdependence test.

Although the U.S. Supreme Court upheld California's application of world-wide unitary taxation in the Container decision, in the opinion of some experts the court did not sufficiently clarify the standard for determining a unitary business. Thus, the question of how to define a unitary business is still open to substantial disagreement.

Application of the unitary concept to foreign corporations

As you know, some States extend the unitary concept to include foreign (non-U.S.) corporations that are considered to be part of the affiliated unitary group. The foreign corporations included in the unitary group can be either the parent corporation of the affiliated corporations or a subsidiary. A parent corporation is generally defined as one owning, either directly or indirectly, more than 50% of the stock of each of the other members of the affiliated group, while a subsidiary corporation is generally defined as one in which the parent has more than 50% ownership.

Most corporations are opposed to world-wide combined reporting for several reasons. Corporate officials believe that the application of world-wide combined reporting results in (1) taxation of foreign-source income, (2) frustration of U.S. foreign commerce, (3) increased risks of international double taxation, (4) over-allocation of income to a State because of the non-comparability between U.S. and foreign apportionment factors, and (5) substantial administrative burdens on multinational corporations. According to the officials, the additional administrative burdens result from the need to (1) determine whether foreign corporations should be included in the unitary business group, (2) translate foreign currency into U.S. dollars, and (3) adjust foreign financial statements to reflect State income tax laws. Most multinational corporate officials consider these administrative requirements especially burdensome when the unitary business includes a parent corporation located in a foreign country. The States which apply world-wide combined reporting told us they do not believe the method results in heavy administrative burdens on the multinational taxpayer. They believe that, for the most part, corporate officials overstate the difficulties.

The issue of world-wide combined reporting has been covered extensively in congressional hearings and was a key aspect of tax treaty negotiations between the United States and Great Britain. The States maintain that the issue involves their ability to generate revenue while corporate taxpayers similarly contend that it significantly alters their tax liability.

In addition, as we documented in our report on State taxation, lack of uniformity among the States causes other problems for States and corporate taxpayers. These problems – namely, higher return preparation costs, potential overtaxation or undertaxation, and numerous disputes – result in a tax system which is unduly uncertain, inefficient, and often inequitable. Substantial nonuniformity exists despite voluntary efforts by the States to achieve greater uniformity.

The Supreme Court has not only recognized the inadequacy of the judicial approach to resolving interstate and international tax issues but as recently as 1978 it commented on the need for a legislative solution:

> It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.

This opinion points out that the Constitution has relegated certain policy decisions to the Congress. Decisions such as those covering State taxation of multijurisdictional corporate income can have potentially broad national and international policy implications. The Congress has the clearest mandate to formulate policy which strikes a balance between the States' authority to tax and the limits on their power to tax. Therefore, the Congress should take the lead in considering the interrelated factors and developing a comprehensive solution.

SUMMARY

In summary, making income adjustments using the arm's length standard has posed administrative burdens on both the IRS and corporate taxpayers. Action taken or being taken by the IRS in response to our recommendations should improve the administration of Sec. 482. However, parties affected by and knowledgeable about arm's length adjustments – officials at the IRS and the Treasury, corporate taxpayers, courts, and experts in the field – have continued to voice substantive criticisms of the overall workability of Sec. 482 regulations.

Some experts have suggested that using the formula apportionment method, when appropriate, would eliminate the need to search for an arm's length price, reduce the administrative burden, and make Sec. 482 enforcement more certain. The States use formula apportionment for those reasons.

We found, however, that the States' use of formula apportionment also raises major issues, particularly when some States use world-wide combined reporting to apply formula apportionment to corporations' foreign operations.

Given the issues and concerns with both the arm's length standard under Sec. 482 and the application of world-wide combined reporting, we believe it is important that the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under Sec. 482. Upon completion of the study, the Treasury should be in a better position to know whether changes are needed and, if so, what changes should be made. That study would also be useful to the Congress should it become involved in considering these issues.

GUAM AGAINST THE U.S.A.

Guam intends to become a financial centre for foreign companies investing in the U.S.A., and, in particular, receiving interest from U.S. sources. An example of a scheme under which interest can be received free from U.S. tax is as follows: a foreign corporation sets up a Guam subsidiary, which holds the shares of a U.S. corporation engaged in trading and business in the U.S.A. It also grants a loan to the U.S. corporation.

Guam, which is a possession of the U.S.A., has a tax code similar to the U.S. Internal Revenue Tax Code (IRC), but, where appropriate, the word "U.S." is replaced by "Guam", and "Guam" by "U.S.".

Interest paid from a U.S. source is subject to 30% tax withheld, if paid to a foreign corporation.[1] However, the IRC provides that a corporation organized under the laws of Guam is not a foreign corporation,[2] and, therefore, the 30% withholding tax does not apply to, say, interest payments to a Guam corporation.

Guam also applies a 30% withholding tax on interest and dividends paid to non-residents. However, where the Guam corporation receives less than 20% of its gross income from sources in Guam, such withholding tax shall not be imposed.[3] The law does not provide that income from a U.S. source is considered Guam-source income.

U.S. Ruling 83-9 and Sec 4a.861-1(a) of the Temporary Income Tax Regulations have blocked this scheme by providing that income of a U.S. corporation derived from sources within Guam that is not subject to income tax in the hands of the recipient shall be considered income from sources within the U.S.A. When mirrored with the Guam Code, this means that the non-taxed interest received from a U.S. source is considered to be income from sources within Guam and therefore that dividends and interest paid by the Guam subsidiary to its foreign parent corporation are subject to the 30% withholding tax.

On 22 November 1983 the Government of Guam lodged a complaint against the U.S. Treasury in the District Court of Guam, and required that both the Ruling and the provisions of the U.S. Temporary Income Tax Regulations be declared, for purposes of Guam taxes, null and void. Guam states that its own tax administration has the exclusive power to interpret the Guam Tax Code.

The U.S. Treasury maintains that although the Guam and the U.S. tax systems are separate, the IRC and the Mirror Code of Guam form an integrated tax system. The purpose of the source rules is to stimulate U.S. investment in Guam, but not to channel income free outside the U.S.A.

1. IRC Sec. 881(a).
2. IRC Sec. 881(b).
3. Mirror of IRC Sec. 861(a)(1)(B).

UNITED STATES: UNITARY TAXATION

Supreme Court Decision in *Container Corporation of America (Appellant) v. Franchise Tax Board* (No. 81-523, 27 June 1983)

HEADNOTE*

California imposes a corporate franchise tax geared to income. It employs the "unitary business" principle and formula apportionment in applying that tax to corporations doing business both inside and outside the State. The formula used – commonly called the "three-factor" formula – is based, in equal parts, on the proportion of a unitary business' total payroll, property, and sales that are located in the State. Appellant paperboard packaging manufacturer is a Delaware corporation headquartered in Illinois and doing business in California and elsewhere. It also has a number of overseas subsidiaries incorporated in the countries in which they operate. In calculating for the tax years in question in this case the share of its net income that was apportionable to California under the three-factor formula, appellant omitted all of its subsidiaries' payroll, property, and sales. Appellee Franchise Tax Board issued notices of additional assessments, the gravamen of which was that appellant should have treated its overseas subsidiaries as part of its unitary business rather than as a passive investment. After paying the additional assessments under protest, appellant brought an action for a refund in California Superior Court, which upheld the additional assessments. The California Court of Appeal affirmed.

Held:

1. California's application of the unitary business principle to appellant and its foreign subsidiaries was proper. [. . .]

(a) The taxpayer has the burden of showing by "clear and convincing evidence" that the state tax results in extra-territorial values being taxed. This Court will, if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a "unitary business". The Court's task is to determine whether the state court applied the correct standards to the case, and, if it did, whether its judgment was within the realm of a permissible judgment. [. . .]

(b) Here, there is no merit to appellant's argument that the Court of Appeal in important part analyzed the case under the incorrect legal standard. Rather, the factors relied upon by the court in holding that appellant and its foreign subsidiaries constituted a unitary business – which factors included appellant's assistance to its subsidiaries in obtaining equipment, in filling personnel needs that could not be met locally, the substantial role played by appellant in loaning funds to the subsidiaries and guaranteeing loans provided by others, the considerable interplay between appellant and its subsidiaries in the area of corporate expansion, the substantial technical assistance provided by appellant to the subsidiaries, and the supervisory role played by appellant's officers in providing general guidance to the subsidiaries – taken in combination clearly demonstrate that the court reached a conclusion "within the realm of permissible judgment." [. . .]

2. California's use of the three-factor formula to apportion the income of the unitary business consisting of appellant and its foreign subsidiaries was fair. Appellant had the burden of proving that the income apportioned to California was out of all appropriate proportions to the business transacted in the State. This burden was not met by offering various statistics that appeared to demonstrate not only that wage rates are generally lower in the foreign countries in which appellant's subsidiaries operate but also that those lower wage rates are not offset by lower levels of productivity. It may well be that in addition to the foreign payroll going into the production of any given corrugated container by a foreign subsidiary, there is a California payroll, as well as other California factors, contributing to the same production. The mere fact that this possibility is not reflected in appellant's accounting does not disturb the underlying premises of the formula apportionment method. [. . .]

3. California had no obligation under the Foreign Commerce Clause to employ the "arm's-length" analysis used by the Federal Government and most foreign nations in evaluating the tax consequences of intercorporate relationships. *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. 434, distinguished. [. . .]

(a) The double taxation occasioned by the California scheme is not impermissible. Due in part to the difference between a tax on income and a tax on tangible property, California would have trouble avoiding double taxation of corporations subject to its franchise tax even if it adopted the arm's-length approach. Moreover, the California tax does not result in "inevitable" double taxation. It would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that sometimes has the same result. [. . .]

(b) The California tax does not violate the "one voice" standard established in *Japan Line, supra,* under which a state tax at variance with federal policy will be struck down if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive. Three factors weigh strongly against the conclusion that the tax might lead to significant foreign retaliation. The tax does not create an *automatic* "asymmetry" in international taxation, it is imposed on a domestic corporation and not on a foreign entity, and even if foreign nations had a legitimate interest in reducing the tax burden of domestic corporations, appellant is amenable to be taxed in California one way or

* Prepared by the Reporter of Decisions for the convenience of the reader.

another and the tax it pays is more the function of California's tax rate than of its allocation method. Moreover, the California tax is not pre-empted by federal law or fatally inconsistent with federal policy. There is no claim that the federal tax statutes themselves provide the necessary pre-emptive force. The requirement of some tax treaties that the Federal Government adopt some form of arm's-length analysis in taxing the domestic income of multinational enterprises is generally waived as to taxes imposed by each of the contracting nations on its own domestic corporations. Tax treaties do not cover the taxing activities of States. And Congress has never enacted legislation designed to regulate state taxation of income. [. . .]

117 Cal. App. 3d 988, 173 Cal. Rptr. 121, affirmed.

BRENNAN, J., delivered the opinion of the Court, in which WHITE, MARSHALL, BLACKMUN, and REHNQUIST, JJ., joined. POWELL, J., filed a dissenting opinion, in which BURGER, C.J., and O'CONNOR, J., joined, STEVENS, J., took no part in the consideration or decision of the case.

THE DECISION

JUSTICE BRENNAN delivered the opinion of the Court.

This is another appeal claiming that the application of a State taxing scheme violates the Due Process and Commerce Clauses of the Federal Constitution. California imposes a corporate franchise tax geared to income. In common with a large number of other States, it employs the "unitary business" principle and formula apportionment in applying that tax to corporations doing business both inside and outside the State. Appellant is a Delaware corporation headquartered in Illinois and doing business in California and elsewhere. It also has a number of overseas subsidiaries incorporated in the countries in which they operate. Appellee is the Californa authority charged with administering the state's franchise tax. This appeal presents three questions for review: (1) Was it improper for appellee and the state courts to find that appellant and its overseas subsidiaries constituted a "unitary business" for purposes of the state tax? (2) Even if the unitary business finding was proper, do certain salient differences among national economies render the standard three-factor apportionment formula used by California so inaccurate as applied to the multinational enterprise consisting of appellant and its subsidiaries as to violate the constitutional requirement of "fair apportionment"? (3) In any event, did California have an obligation under the Foreign Commerce Clause, U.S. Const., Art. I, §8, cl. 3, to employ the "arm's-length" analysis used by the federal government and most foreign nations in evaluating the tax consequences of inter-corporate relationships?

I

A

Various aspects of state tax systems based on the "unitary business" principle and formula apportionment have provoked repeated constitutional litigation in this Court. [. . .]

Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, "tax value earned outside its borders." [. . .] In the case of a more-or-less integrated business enterprise operating in more than one State, however, arriving at precise territorial allocations of "value" is often an elusive goal, both in theory and in practice. [. . .] For this reason and others, we have long held that the Constitution imposes no single formula on the States, [. . .], and that the taxpayer has the "distinct burden of showing by 'clear and cogent evidence' that [the state tax] results in extraterritorial values being taxed . . . ." [. . .]

One way of deriving locally taxable income is on the basis of formal geographical or transactional accounting. The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise. [. . .] The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction. This Court long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints. [. . .] The method has now gained wide acceptance, and is in one of its forms the basis for the Uniform Division of Income for Tax Purposes Act (Uniform Act), which has at last count been substantially adopted by 23 States, including California.

B

Two aspects of the unitary business/formula apportionment method have traditionally attracted judicial attention. These are, as one might easily guess, the notions of "unitary business" and "formula apportionment," respectively.

(1)

The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities – even on a proportional basis – unless there is a "minimal connection" or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" [. . .] At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported "unitary business" unless at least some part of it is conducted in the State. [. . .] It also requires that there be some bond of ownership or control uniting the purported "unitary business." [. . .]

In addition, the principles we have quoted require that the out-of-State activities of the purported "unitary business" be related in some concrete way to the in-State activities. The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation. [. . .] we held that a State could tax on an apportioned basis the combined income of a vertically integrated business whose various components (manufacturing, sales, etc.) operated in different States. [. . .] we applied the same principle to a vertically integrated business operating across national boundaries.

[. . .] we recognized that the unitary business principle could apply, not only to vertically integrated enterprises, but also to a series of similar enterprises operating separately in various jurisdictions but linked by common managerial or operational resources that produced economies of scale and transfers of value. More recently, we have further refined the "unitary business" concept. [. . .]

The California statute at issue in this case, and the Uniform Act from which most of its relevant provisions are derived, tracks in large part the principles we have just discussed. In particular, the statute distinguishes between the "business income" of a multi-jurisdictional enterprise, which is apportioned by formula, Cal. Rev. & Tax. Code Ann. §§25128-25136, and its "non-business" income, which is not.[1] Although the statute does not explicitly require that income from distinct business enterprises be apportioned separately, this requirement antedated adoption of the Uniform Act,[2] and has not been abandoned.[3]

A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach. For example, a State might decide to respect formal corporate lines and treat the ownership of a corporate subsidiary as per se a passive investment.[4] In *Mobil Oil Corp.,* 445 U.S., at 440-444, however, we made clear that, as a general matter, such a per se rule is not constitutionally required:

> Superficially, intercorporate division might appear to be a[n] . . . attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Id., at 440.

Thus, for example, California law provides:

> In the case of a corporation . . . owning or controlling, either directly or indirectly, another corporation, or other corporations, and in the case of a corporation . . . owned or controlled, either directly or indirectly, by another corporation, the Franchise Tax Board may require a consolidated report showing the combined net income or such other facts as it deems necessary. Cal. Rev. & Tax. Code Ann. §25104 (West 1979).[5]

Even among States that take this approach, however, only some apply it in taxing American corporations with subsidiaries located in foreign countries.[6] The difficult question we address in Part V of this opinion is whether, for reasons not implicated in *Mobil,*[7] that particular variation on the theme is constitutionally barred.

(2)

Having determined that a certain set of activities constitute a "unitary business," a State must then apply a formula apportioning the income of that business within and without the State. Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. [. . .]

The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency – that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency – the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not "invalidate[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State . . ." [. . .] Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to

1. Certain forms of non-business income, such as dividends, are allocated on the basis of the taxpayer's commercial domicile. Other forms of non-business income, such as capital gains on sales of real property, are allocated on the basis of situs. See Cal. Rev. & Tax. Code Ann. §§25123-25127 (West 1979).
2. See generally *Honolulu Oil Corp.* v. *Franchise Tax Board,* 60 Cal. 2d 417, 386 P. 2d 40 (1983); *Superior Oil Corp.* v. *Franchise Tax Board,* 60 Cal. 2d 406, 386 P. 2d 33 (1963).
3. See the opinion of the California Court of Appeal in this case, 117 Cal. App. 3d 988, 990-991, 993-995 (1982). See also Cal. Rev. & Tax. Code Ann. §25137 (West 1979) (allowing for separate accounting or other alternative methods of apportionment when total formula apportionment would "not fairly represent the extent of the taxpayer's business activity in the state").
4. We note that the Uniform Act does not speak to this question one way or the other.
5. See also Cal. Rev. & Tax. Code Ann. §25105 (West 1979) (defining "ownership or control"). A necessary corollary of the California approach, of course, is that inter-corporate dividends in a unitary business *not* be included in gross income, since such inclusion would result in double-counting of a portion of the subsidiary's income (first as income attributed to the unitary business, and second as dividend income to the parent). See §25106.
Some States, it should be noted, have adopted a hybrid approach. In *Mobil* itself, for example, a non-domiciliary State invoked a unitary business justification to include an apportioned share of certain corporate dividends in the gross income of the taxpayer, but did not require a combined return and combined apportionment. The Court in *Mobil* held that the taxpayer's objection to this approach had not been properly raised in the state proceedings. 445 U.S., at 441, n. 15. JUSTICE STEVENS, however, reached the merits, stating in part: "Either Mobil's worldwide 'petroleum enterprise' is all part of one unitary business, or it is not; if it is, Vermont must evaluate the entire enterprise in a consistent manner". Id., at 461 (citation omitted). See id., at 462 (STEVENS, J., dissenting) (outlining alternative approaches available to State); cf. The Supreme Court, 1981 Term, 96 Harv. L. Rev. 62, 93-96 (1982).
6. See generally G.A.O. Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving 31 (1982).
7. *Mobil* did, in fact, involve income from foreign subsidiaries, but that fact was of little importance to the case for two reasons. First, as discussed in n. 5, supra, the State in that case included *dividends* from the subsidiaries to the parent in its calculation of the parent's apportionable taxable income, but did not include the underlying income of the subsidiaries themselves. Second, the taxpayer in that case conceded that the dividends could be taxed *somewhere* in the United States, so the actual issue before the Court was merely whether a particular State could be barred from imposing some portion of that tax. See 445 U.S., at 447.

the State is in fact 'out of all appropriate proportions to the business transacted in that State,' [. . .] or has 'led to a grossly distorted result'. [. . .]

California and the other States that have adopted the Uniform Act use a formula – commonly called the "three-factor" formula – which is based, in equal parts, on the proportion of a unitary business's total payroll, property, and sales which are located in the taxing State. See Cal. Code Ann. §§25128-25136 (West 1979). We approved the three-factor formula. [. . .] Indeed, not only has the three-factor formula met our approval, but it has become, for reasons we discuss in more detail infra [. . .] something of a benchmark against which other apportionment formulas are judged. [. . .]

Besides being fair, an apportionment formula must, under the Commerce Clause, also not result in discrimination against interstate or foreign commerce. [. . .] Aside from forbidding the obvious types of discrimination against interstate or foreign commerce, this principle might have been construed to require that a state apportionment formula not differ so substantially from methods of allocation used by other jurisdictions in which the taxpayer is subject to taxation so as to produce double taxation of the same income, and a resultant tax burden higher than the taxpayer would incur if its business were limited to any one jurisdiction. At least in the interstate commerce context, however, the antidiscrimination principle has not in practice required much in addition to the requirement of fair apportionment. [. . .] in particular, we explained that eliminating all overlapping taxation would require this Court to establish not only a single constitutionally mandated method of taxation, but also rules regarding the application of that method in particular cases. [. . .] Because that task was thought to be essentially legislative, we declined to undertake it, and held that a fairly apportioned tax would not be found invalid simply because it differed from the prevailing approach adopted by the States. As we discuss infra, [. . .] however, a more searching inquiry is necessary when we are confronted with the possibility of international double taxation.

II

A

Appellant is in the business of manufacturing custom-ordered paperboard packaging. Its operation is vertically integrated, and includes the production of paperboard from raw timber and wastepaper as well as its composition into the finished products ordered by customers. The operation is also largely domestic. During the years at issue in this case – 1963, 1964, and 1965 – appellant controlled 20 foreign subsidiaries located in four Latin American and four European countries. Its percentage ownership of the subsidiaries (either directly or through other subsidiaries) ranged between 66.7% and 100%. In those instances (about half) in which appellant did not own a 100% interest in the subsidiary, the remainder was owned by local nationals. One of the subsidiaries was a holding company that had no payroll, sales, or property, but did have book income. Another was inactive. The rest were all engaged – in their respective local markets – in essentially the same business as appellant.

Most of appellant's subsidiaries were, like appellant itself, fully integrated, although a few bought paperboard and other intermediate products elsewhere. Sales of materials from appellant to its subsidiaries accounted for only about 1% of the subsidiaries' total purchases. The subsidiaries were also relatively autonomous with respect to matters of personnel and day-to-day management. For example, transfers of personnel from appellant to its subsidiaries were rare, and occurred only when a subsidiary could not fill a position locally. There was no formal United States training program for the subsidiaries' employees, although groups of foreign employees occasionally visited the United States for 2-6 week periods to familiarize themselves with appellant's methods of operation. Appellant charged one senior vice-president and four other officers with the task of overseeing the operations of the subsidiaries. These officers established general standards of professionalism, profitability, and ethical practices and dealt with major problems and long-term decisions; day-to-day management of the subsidiaries, however, was left in the hands of local executives who were always citizens of the host country. Although local decisions regarding capital expenditures were subject to review by appellant, problems were generally worked out by consensus rather than outright domination. Appellant also had a number of its directors and officers on the boards of directors of the subsidiaries, but they did not generally play an active role in management decisions.[8]

Nevertheless, in certain respects, the relationship between appellant and its subsidiaries was decidedly close. For example, approximately half of the subsidiaries' long-term debt was either held directly, or guaranteed, by appellant. Appellant also provided advice and consultation regarding manufacturing techniques, engineering, design, architecture, insurance, and cost accounting to a number of its subsidiaries, either by entering into technical service agreements with them or by informal arrangement. Finally, appellant occasionally assisted its subsidiaries in their procurement of equipment, either by selling them used equipment of its own or by employing its own purchasing department to act as an agent for the subsidiaries.[9]

B

During the tax years at issue in this case, appellant filed California franchise tax returns. In 1969, after conducting an audit of appellant's returns for the years in ques-

8. There were a number of reasons for appellant's relatively hands-off attitude toward the management of its subsidiaries. First, it comported with the company's general management philosophy emphasizing local responsibility and accountability; in this respect, the treatment of the foreign subsidiaries was similar to the organization of appellant's domestic geographical divisions. Second, it reflected the fact that the packaging industry, like the advertising industry to which it is closely related, is highly sensitive to differences in consumer habits and economic development among different nations, and therefore requires a good dose of local expertise to be successful. Third, appellant's policy was designed to appeal to the sensibilities of local customers and governments.

9. There was also a certain spill-over of good-will between appellant and its subsidiaries; that is, appellant's customers who had overseas needs would on occasion ask appellant's sales representatives to recommend foreign firms, and where possible, the representatives would refer the customers to appellant's subsidiaries. In at least one instance, appellant became involved in the actual negotiation of a contract between a customer and a foreign subsidiary.

tion, appellee issued notices of additional assessments for each of those years. The respective approaches and results reflected in appellant's initial returns and in appellee's notices of additional assessments capture the legal differences at issue in this case.[10]

In calculating the total unapportioned taxable income of its unitary business, appellant included its own corporate net earnings as derived from its federal tax form (subject to certain adjustments not relevant here), but did not include any income of its subsidiaries. It also deducted – as it was authorized to do under state law, [. . .] all dividend income, non-business interest income, and gains on sales of assets not related to the unitary business. In calculating the share of its net income which was apportionable to California under the three-factor formula, appellant omitted all of its subsidiaries' payroll, property, and sales. The results of these calculations are summarized in the margin.[11]

The gravamen of the notices issued by appellee in 1969 was that appellant should have treated its overseas subsidiaries as part of its unitary business rather than as passive investments. Including the overseas subsidiaries in appellant's unitary business had two primary effects; it increased the income subject to apportionment by an amount equal to the total income of those subsidiaries (less inter-subsidiary dividends, [. . .]), and it decreased the percentage of that income which was apportionable to California. The net effect, however, was to increase appellant's tax liability in each of the three years.[12]

Appellant paid the additional amounts under protest, and then sued in California Superior Court for a refund, raising the issues now before this Court. The case was tried on stipulated facts, and the Superior Court upheld appellee's assessments. On appeal, the California Court of Appeal affirmed, 177 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981), and the California Supreme Court refused to exercise discretionary review. We noted probable jurisdiction. 456 U.S. 960 (1982).

III

A

We address the unitary business issue first. As previously noted, the taxpayer always has the "distinct burden of showing by 'clear and cogent evidence' that [the state tax] results in extraterritorial values being taxed." [. . .] One necessary corollary of that principle is that this Court will, if reasonablly possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a "unitary business". As we said in a closely related context in *Norton Co.* v. *Dept. of Revenue,* 340 U.S. 543 (1951):

> The general rule, applicable here, is that a taxpayer claiming immunity from a tax has the burden of establishing his exemption.
> *This burden is never met merely by showing a fair difference of opinion which as an original matter might be decided differently* . . . Of course, in constitutional cases, we have power to examine the whole record to arrive at an independent judgment as to whether constitutional rights have been invaded, but that does not mean that we will reexamine, as a court of first instance, findings of fact supported by substantial evidence. Id., at 537-538 (footnotes omitted; emphasis added).[13]

See id., at 538 (concluding that, "in light of all the evidence, the [state] judgment [on a question of whether income should be attributed to the State] was within the realm of permissible judgment."). The legal principles defining the constitutional limits on the unitary business principle are now well established. The factual records in such cases, even when the parties enter into a stipulation, tend to be long and complex, and the line between "historical fact" and "constitutional fact" is often fuzzy at best. [. . .] It will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a de novo adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment.[14] Rather, our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment "was within the realm of permissible judgment."[15]

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10. After the notices of additional tax, there followed a series of further adjustments, payments, claims for refunds, and assessments, whose combined effect was to render the figures outlined in text more illustrative than real as descriptions of the present claims of the parties with regard to appellant's total tax liability. These subsequent events, however, did not concern the legal issues raised in this case, nor did they remove either party's financial stake in the resolution of those issues. We therefore disregard them for the sake of simplicity.

11.

	1963	*1964*	*1965*
Total income of unitary business	$26,870,427.00	$28,774,320.48	$32,280,842.90
Percentage attributed to Calif.	11.041%	10.6422%	9.8336%
Amount attributed to Calif.	2,966,763.85	3,062,220.73	3,174,368.97
Tax (5.5%)	163,172.01	168,422.14	174,590.29

See Exhibit A-7 to Stipulation; Record 36, 76, 77, 79, 104, 126.

12. According to the notices, appellant's actual tax obligations were as follows:

	1963	*1964*	*1965*
Total income of unitary business	$37,348,183.00	$44,245,879.00	$46,884,966.00
Percentage attributed to Calif.	8.6886%	8.3135%	7.6528%
Amount attributed to Calif.	3,245,034.23	3,673,381.15	3,588,012.68
Tax (5.5%)	178,476.88	202,310.95	197,340.70

See Exhibit A-7 to Stipulation; Record 76, 77, 79.

13. This approach is, of course, quite different from the one we follow in certain other constitutional contexts. See, e.g., *Brooks* v. *Florida,* 389 U.S. 413 (1967); *New York Times Co.* v. *Sullivan,* 376 U.S. 254, 285 (1964).

14. It should also go without saying that not every claim that a state court erred in making a unitary business finding will pose a substantial federal question in the first place.

15. *ASARCO* and *F.W. Woolworth* are consistent with this standard of review. *ASARCO* involved a claim that a parent and certain of its partial subsidiaries, in which it held either minority interests or bare majority interests, were part of the same unitary business. The state supreme court upheld the claim. We concluded, *relying on factual findings made by the state courts,* that a unitary business finding was impermissible because the partial subsidiaries were not realistically subject to even minimal control by ASARCO, and were therefore passive investments in the most basic sense of the term. [. . .] We held specifically that to accept the state's theory of the case would not only constitute a misapplication of the unitary business concept, but would "destroy" the concept entirely. [. . .]
F.W. Woolworth was a much closer case, involving one partially-owned and three wholly-owned subsidiaries. We examined the evidence in some detail, and reversed the state court's unitary business finding, but only after concluding that the state court had made specific and crucial legal errors, not merely in the conclusions it drew, but in the legal standard it applied in analyzing the case. [. . .]

B

In this case, we are singularly unconvinced by appellant's argument that the state Court of Appeal "in important part analyzed this case under a different legal standard," [. . .] from the one articulated by this Court. Appellant argues that the state court here, [. . .] improperly relied on appellant's mere *potential* to control the operations of its subsidiaries as a dispositive factor in reaching its unitary business finding. In fact, although the state court mentioned that "major policy decisions of the subsidiaries were subject to review by appellant," 117 Cal. App. 3d, at 998, 173 Cal. Rptr., at 127, it relied principally, in discussing the management relationship between appellant and its subsidiaries, on the more concrete observation that "[h]igh officials of appellant gave directions to subsidiaries for compliance with the parent's standard of professionalism, profitability, and ethical practices." Id., at 998, 173 Cal. Rptr., at 127-128.[16]

Appellant also argues that the state court erred in endorsing an administrative presumption that corporations engaged in the same line of business are unitary. This presumption did enter into the state court's reasoning, but only as one element among many. Moreover, considering the limited use to which it was put, we find the "presumption" criticized by appellant to be reasonable. Investment in a business enterprise truly "distinct" from a corporation's main line of business often serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle. When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources.

Finally, appellant urges us to adopt a bright-line rule requiring as a prerequisite to a finding that a mercantile or manufacturing enterprise is unitary that it be characterized by "a substantial flow of goods." Brief for Appellant 47. We decline this invitation. The prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value,* not a flow of goods.[17] As we reiterated [. . .] a relevant question in the unitary business inquiry is whether "contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale." [. . .] "[S]ubstantial mutual interdependence," [. . .] can arise in any number of ways; a substantial flow of goods is clearly one but just as clearly not the only one.

C

The state Court of Appeal relied on a large number of factors in reaching its judgment that appellant and its foreign subsidiaries constituted a unitary business. These included appellant's assistance to its subsidiaries in obtaining used and new equipment and in filling personnel needs that could not be met locally, the substantial role played by appellant in loaning funds to the subsidiaries and guaranteeing loans provided by others, the "considerable interplay between appellant and its foreign subsidiaries in the area of corporate expansion," 117 Cal. App. 3d, at 997, 173 Cal. Rptr., at 127, the "substantial" technical assistance provided by appellant to the subsidiaries, id., at 998-999, and the supervisory role played by appellant's officers in providing general guidance to the subsidiaries. [. . .][18] We need not decide whether any of these factors would be sufficient as constitutional matter to prove the existence of a unitary business. Taken in combination, at least, they clearly demonstrate that the state court reached a conclusion "within the realm of permissible judgment."[19]

IV

We turn now to the question of fair apportionment. Once again, appellant has the burden of proof; it must demonstrate that "there is no rational relationship between the income attributed to the State and the intrastate values of the enterprise," [. . .] by proving that the

16. In any event, although potential control is, as we said in *F.W. Woolworth*, not *"dispositive"* of the unitary business issue, [. . .] (emphasis added), it is *relevant,* both to whether or not the components of the purported unitary business share that degree of common ownership which is a prerequisite to a finding of unitariness, and also to whether there might exist a degree of implicit control sufficient to render the parent and the subsidiary an integrated enterprise.

17. As we state supra, [. . .] there is a wide range of constitutionally acceptable variations on the unitary business theme. Thus, a leading scholar has suggested that a "flow of goods" requirement would provide a reasonable and workable bright-line test for unitary business, see Hellerstein, Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business, 21 Nat'l Tax J. 487, 501-502 (1968); Hellerstein, Allocation and Apportionment of Dividends and the Delineation of the Unitary Business, 27 Tax Notes 155 (1981), and some state courts have adopted such a test, see, e.g., *Commonwealth* v. *ACF Industries, Inc.,* 441 Pa. 129, 271 A. 2d 273 (1970). But see, e.g., McLure, Operational Interdependence Is Not The Appropriate 'Bright Line Test' of A Unitary Business – At Least Not Now, 28 Tax Notes 107 (1983). However sensible such a test may be as a policy matter, however, we see no reason to impose it on all the States as a requirement of constitutional law. Cf. *Wisconsin* v. *J.C. Penney Co.,* 311 U.S. 435, 445 (1940).

18. See n. 15, Supra. See also, e.g., *F.W. Woolworth,* [. . .] (*"no* phase of any subsidiary's business was integrated with the parent's."), – (undisputed testimony stated that each subsidiary made business decisions independent of parent) – ("each subsidiary was responsible for obtaining its own financing from sources other than the parent"), – ("With one possible exception, none of the subsidiaries' officers during the year in question was a current or former employee of the parent.") (footnote omitted).

19. Two of the factors relied on by the state court deserve particular mention. The first of these is the flow of capital resources from appellant to its subsidiaries through loans and loan guarantees. There is no indication that any of these capital transactions were conducted at arm's-length, and the resulting flow of value is obvious. As we made clear in another context in *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 50-53 (1955), capital transactions can serve either an investment function or an operational function. In this case, appellant's loans and loan guarantees were clearly part of an effort to insure that "[t]he overseas operations of [appellant] continue to grow and to become a more substantial part of the company's strength and profitability." Container Corporation of America, 1964 Annual Report 6, reproduced in Exhibit I to Stipulation of Facts. See generally id., at 6-9, 11.

The second noteworthy factor is the managerial role played by appellant in its subsidiaries' affairs. We made clear in *F.W. Woolworth Co.* that a unitary business finding could not be based merely on "the type of occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary . . ." [. . .] As *Exxon* illustrates, however, mere decentralization of day-to-day management responsibility and accountability cannot defeat a unitary business finding. 447 U.S., at 224. The difference lies in whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy. In this case, the business "guidelines" established by appellant for its subsidiaries, the "consensus" process by which appellant's management was involved in the subsidiaries' business decisions, and the sometimes uncompensated technical assistance provided by appellant, all point to precisely the sort of operational role we found lacking in *F.W. Woolworth.*

income apportioned to California under the statute is "out of all appropriate proportions to the business transacted in that State." [. . .]

Appellant challenges the application of California's three-factor formula to its business on two related grounds, both arising as a practical (although not a theoretical) matter out of the international character of the enterprise. First, appellant argues that its foreign subsidiaries are significantly more profitable than it is, and that the three-factor formula, by ignoring that fact and relying instead on indirect measures of income such as payroll, property, and sales, systematically distorts the true allocation of income between appellant and the subsidiaries. The problem with this argument is obvious; the profit figures relied on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place. Indeed, we considered and rejected a very similar argument in *Mobil*, pointing out that whenever a unitary business exists,

> separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source'. Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required. 445 U.S., at 438 (citation omitted).

Appellant's second argument is related, and can be answered in the same way. Appellant contends that:

> The costs of production in foreign countries are generally significantly lower than in the United States, primarily as a result of the lower wage rates of workers in countries other than the United States. Because wages are one of the three factors used in formulary apportionment, the use of the formula unfairly inflates the amount of income apportioned to United States operations, where wages are higher. Brief for Appellant 12.

Appellant supports this argument with various statistics that appear to demonstrate, not only that wage rates are generally lower in the foreign countries in which its subsidiaries operate, but also that those lower wages are not offset by lower levels of productivity. Indeed, it is able to show that at least one foreign plant had labor costs per thousand square feet of corrugated container that were approximately 40% of the same costs in appellant's California plants.

The problem with all this evidence, however, is that it does not by itself come close to impeaching the basic rationale behind the three-factor formula. Appellant and its foreign subsidiaries have been determined to be a unitary business. It therefore may well be that in addition to the foreign payroll going into the production of any given corrugated container by a foreign subsidiary, there is also California payroll, as well as other California factors, contributing – albeit more indirectly – to the same production. The mere fact that this possibility is not reflected in appellant's accounting does not disturb the underlying premises of the formula apportionment method.

Both geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory. Some methods of formula apportionment are particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated. Although we have generally upheld the use of such formulas, [. . .] we have on occasion found the distortive effect of focusing on only one factor so outrageous in a particular case as to require reversal. In *Hans Rees' Sons, Inc.* v. *North Carolina ex re Maxwell*, 238 U.S. 123 (1931), for example, an apportionment method based entirely on ownership of tangible property resulted in an attribution to North Carolina of between 66 and 85% of the taxpayer's income over the course of a number of years, while a separate accounting analysis purposely skewed to resolve all doubts in favor of the State resulted in an attribution of no more than 21.7%. We struck down the application of the one-factor formula to that particular business, holding that the method, "albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." [. . .]

The three-factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. It is therefore able to avoid the sorts of distortions that were present in *Hans Rees' Sons, Inc.*

Of course, even the three-factor formula is necessarily imperfect.[20] But we have seen no evidence demonstrating that the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by appellant. Indeed, it would be difficult to come to such a conclusion on the basis of the figures in this case: for all of appellant's statistics showing allegedly enormous distortions caused by the three-factor formula, the tables we set out at nn. 11-12, supra, reveal that the percentage increase in taxable income attributable to California between the methodology employed by appellant and the methodology employed by appellee comes to approximately 14%, a far cry from the more than 250% difference which led us to strike down the state tax in *Hans Rees' Sons, Inc.*, and a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business. [. . .]

20. First, the one-third-each weight given to the three factors is essentially arbitrary. Second, payroll, property, and sales still do not exhaust the entire set of factors arguably relevant to the production of income. Finally, the relationship between each of the factors and income is by no means exact. The three-factor formula, as applied to horizontally linked enterprises, is based in part on the very rough economic assumption that rates of return on property and payroll – as such rates of return would be measured by an ideal accounting method that took all transfers of value into account – are roughly the same in different taxing jurisdictions. This assumption has a powerful basis in economic theory: if true rates of return were radically different in different jurisdictions, one might expect a significant shift in investment resources to take advantage of that difference. On the other hand, the assumption has admitted weaknesses: an enterprise's willingness to invest simultaneously in two jurisdictions with very different true rates of return might be adequately explained by, for example, the difficulty of shifting resources, the decreasing marginal value of additional investment, and portfolio-balancing considerations.

V

For the reasons we have just outlined, we conclude that California's application of the unitary business principle to appellant and its foreign subsidiaries was proper, and that its use of the standard three-factor formula to apportion the income of that unitary business was fair. This proper and fair method of taxation happens, however, to be quite different from the method employed both by the Federal Government in taxing appellant's business, and by each of the relevant foreign jurisdictions in taxing the business of appellant's business, and by each of the relevant foreign jurisdictions in taxing the business of appellant's subsidiaries. Each of these other taxing jurisdictions has adopted a qualified separate accounting approach – often referred to as the "arm's-length" approach – to the taxation of related corporations.[21] Under the arm's-length approach, every corporation, even if closely tied to other corporations, is treated for most – but decidedly not all – purposes as if it were an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books.

If the unitary business consisting of appellant and its subsidiaries were entirely domestic, the fact that different jurisdictions applied different methods of taxation to it would probably make little constitutional difference, for the reasons we discuss supra, [. . .] Given that it is international, however, we must subject this case to the additional scrutiny required by the Foreign Commerce Clause. [. . .] The case most relevant to our inquiry is *Japan Line.*

A

Japan Line involved an attempt by California to impose an apparently fairly apportioned, nondiscriminatory, ad valorem property tax on cargo containers which were instrumentalities of foreign commerce and which were temporarily located in various California ports. The same cargo containers, however, were subject to an unapportioned property tax in their home port of Japan. Moreover, a convention signed by the United States and Japan made clear, at least, that neither national government could impose a tax on temporarily imported cargo containers whose home port was in the other nation. We held that "[w]hen a State seeks to tax the instrumentalities of foreign commerce, two additional considerations, beyond those articulated in [the doctrine governing the Interstate Commerce Clause], come into play." 441 U.S., at 446. The first is the enhanced risk of multiple taxation. Although consistent application of the fair apportionment standard can generally mitigate, if not eliminate, double taxation in the domestic context,

> neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results . . . Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce '"to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.'" [. . .]

The second additional consideration that arises in the foreign commerce context is the possibility that a state tax will "impair federal uniformity in an area where federal uniformity is essential," 441 U.S., at 448:

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions . . . If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign commerce. Id., at 450-451 (footnote omitted).

On the basis of the facts in *Japan Line*, we concluded that the California tax at issue was constitutionally improper because it failed to meet either of the additional tests mandated by the Foreign Commerce Clause. Id., at 451-454.

This case is similar to *Japan Line* in a number of important respects. First, the tax imposed here, like the tax imposed in *Japan Line*, has resulted in actual double taxation, in the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part.[22] Second, that double taxation stems from a serious divergence in the taxing schemes adopted by California and the foreign taxing authorities. Third, the taxing method adopted by those foreign taxing authorities is consistent with accepted international practice. Finally, our own Federal Government, to the degree it has spoken, seems to prefer the taxing method adopted by the international community to the taxing method adopted by California.[23]

Nevertheless, there are also a number of ways in which

21. The arm's-length approach is also often applied to geographically distinct divisions of a single corporation.

22. The stipulation of facts indicates that the tax returns filed by appellant's subsidiaries in their foreign domiciles took into account "only the applicable income and deductions incurred by the subsidiary or subsidiaries in that country and not . . . the income and deductions of [appellant] or the subsidiaries operating in other countries." App. 72. This does not conclusively demonstrate the existence of double taxation because appellant has not produced its foreign tax returns, and it is entirely possible that deductions, exemptions, or adjustments in those returns eliminated whatever overlap in taxable income resulted from the application of the California apportionment method. Nevertheless, appellee does not seriously dispute the existence of actual double taxation as we have defined it, Brief for Appellee 114-121, but cf. Tr. of Oral Arg. 28-29, and we assume its existence for the purposes of our analysis. Cf. *Japan Line,* 441 U.S., at 452, n. 17.

23. But see infra, [. . .] (discussing whether state scheme is preempted by federal law).

this case is clearly distinguishable from *Japan Line.*[24] First, it involves a tax on income rather than a tax on property. We distinguished property from income taxation in *Mobil Oil Corp.*, 445 U.S., at 444-446, and *Exxon Corp.*, 447 U.S., at 228-229, suggesting that "[t]he reasons for allocation to a single situs that often apply in the case of property taxation carry little force" in the case of income taxation. 445 U.S., at 445. Second, the double taxation in this case, although real, is not the "inevitabl[e] result of the California taxing scheme. Cf. *Japan Line,* 441 U.S., at 447. In *Japan Line,* we relied strongly on the fact that one taxing jurisdiction claimed the right to tax a given value in full, and another taxing jurisdiction claimed the right to tax the same entity in part – a combination resulting necessarily in double taxation. 441 U.S., at 447, 452, 455. Here, by contrast, we are faced with two distinct methods of allocating the income of a multi-national enterprise. The "arm's-length" approach divides the pie on the basis of formal accounting principles. The formula apportionment method divides the same pie on the basis of a mathematical generalization. Whether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case.[25] The third difference between this case and *Japan Line* is that the tax here falls, not on the foreign owner of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States. We specifically left open in *Japan Line* the application of that case to "domestically owned instrumentalities engaged in foreign commerce," 441 U.S., at 444, n. 7, and – to the extent that corporations can be analogized to cargo containers in the first place – this case falls clearly within that reservation.[26]

In light of these considerations, our task in this case must be to determine whether the distinctions between the present tax and the tax at issue in *Japan Line* add up to a constitutionally significant difference. For the reasons we are about to explain, we conclude that they do.

B

In *Japan Line,* we said that "[e]ven a slight overlapping of tax – a problem that might be deemed de minimis in a domestic context – assumes importance when sensitive matters of foreign relations and national sovereignty are concerned". 441 U.S., at 456 (footnote omitted). If we were to take that statement as an absolute prohibition on state-induced double taxation in the international context, then our analysis here would be at an end. But, in fact, such an absolute rule is no more appropriate here than it was in *Japan Line* itself, where we relied on much more than the mere fact of double taxation to strike down the state tax at issue. Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to the taxing State.

In *Japan Line,* the taxing State could entirely eliminate one important source of double taxation simply by adhering to one bright-line rule: do not tax, to any extent whatsoever, cargo containers "that are owned, based, and registered abroad and that are used exclusively in international commerce . . ." 441 U.S., at 444. To require that the State adhere to this rule was by no means unfair, because the rule did no more than reflect consistent international practice and express federal policy. In this case, California could try to avoid double taxation simply by not taxing appellant's income at all, even though a good deal of it is plainly domestic. But no party has suggested such a rule, and its obvious unfairness requires no elaboration. Or California could try to avoid double taxation by adopting some version of the "arm's-length" approach. That course, however, would not by any means guarantee an end to double taxation.

As we have already noted, the arm's-length approach is generally based, in the first instance, on a multi-corporate enterprise's own formal accounting. But, despite that initial reliance, the arm's-length approach recognizes, as much as the formula apportionment approach, that closely related corporations can engage in a transfer of values that is not fully reflected in their formal ledgers. Thus, for example, 26 U.S.C. §482 provides:

> In any cases of two or more . . . businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary [of the Treasury] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such . . . businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such . . . businesses.[27]

And, as one might expect, the United States Internal Revenue Service has developed elaborate regulations in order to give content to this general provision. Many other countries have similar provisions.[28] A serious problem, however, is that even though most nations have adopted the arm's-length approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substan-

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24. Note that we deliberately emphasized in *Japan Lines* the narrowness of the question presented: "whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State." 441 U.S., at 444.

25. Indeed, in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.,* No. 81-349, which was argued last Term and carried over to this Term, application of worldwide combined apportionment resulted in a refund to the taxpayer from the amount he had paid under a tax return that included neither foreign income nor foreign apportionment factors.

26. We have no need to address in this opinion the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries. See also n. 32, infra.

27. Cf. United States Draft Model Income Tax Treaty of June 16, 1981, Art. 9, reprinted in P-H Tax Treaties ¶ 1022 (hereinafter Model Treaty) ("Where . . . an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State . . . and . . . conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for these conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly."); J. Bischel, Income Tax Treaties 219 (1978) (hereinafter Bischel).

28. See generally G. Harley, International Division of the Income Tax Base of Multinational Enterprises 143-160 (1981) (hereinafter Harley); Madare, International Pricing: Allocation Guidelines and Relief from Double Taxation, 10 Tex. Int'l L.J. 108, 111-120 (1975).

tially, and whenever that difference exists, the possibility of double taxation also exists.[29] Thus, even if California were to adopt some version of the arm's-length approach, it could not eliminate the risk of double taxation of corporations subject to its franchise tax, and might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.[30]

That California would have trouble avoiding double taxation even if it adopted the arm's-length approach is, we think, a product of the difference between a tax on income and a tax on tangible property. See supra. [. . .] Allocating income among various taxing jurisdictions bears some resemblance, as we have emphasized throughout this opinion, to slicing a shadow. In the absence of a central coordinating authority, absolute consistency, even among taxing authorities whose basic approach to the task is quite similar, may just be too much to ask.[31] If California's method of formula apportionment "inevitably" led to double taxation, see supra [. . .] that might be reason enough to render it suspect. But since it does not, it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation. [. . .]

It could be argued that even if the Foreign Commerce Clause does not require California to adopt the arm's-length approach to foreign subsidiaries of domestic corporations, it does require that whatever system of taxation California adopts must not result in double taxation in any particular case. The implication of such a rule, however, would be that even if California adopted the arm's-length method, it would be required to defer, not merely to a single internationally accepted bright line standard, as was the case in *Japan Line*, but to a variety of §482-type reallocation decisions made by individual foreign countries in individual cases. Although double taxation is a constitutionally disfavored state of affairs, particularly in the international context, *Japan Line* does not require forbearance so extreme or so one-sided.

C

We come finally to the second inquiry suggested by *Japan Line* – whether California's decision to adopt formula apportionment in the international context was impermissible because it "may impair federal uniformity in an area where federal uniformity is essential," 441 U.S., at 448, and "prevents the Federal Government from 'speaking with one voice' in international trade," id., at 453, quoting *Michelin Tire Corp.* v. *Wages,* 423 U.S. 276, 285 (1976). In conducting this inquiry, however, we must keep in mind that if a state tax merely has foreign resonances, but does not implicate foreign affairs, we cannot infer, "[a]bsent some explicit directive from Congress, . . . that treatment of foreign income at the federal level mandates identical treatment by the States." [. . .] Thus, a state tax at variance with federal policy will violate the "one voice" standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive. The second of these considerations is, of course, essentially a species of preemption analysis.

(1)

The most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the nation as a whole. 441 U.S., at 450. In considering this issue, however, we are faced with a distinct problem. This Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please. The best that we can do, in the absence of explicit action by Congress, is to attempt to develop objective standards that reflect very general observations about the imperatives of international trade and international relations.

This case is not like *Mobil,* in which the real issue came down to a question of interstate rather than foreign commerce. 445 U.S., at 446-449. Nevertheless, three distinct factors, which we have already discussed in one way or another, seem to us to weigh strongly against the conclusion that the tax imposed by California might justifiably lead to significant foreign retaliation. First, the tax here does not create an *automatic* "asymmetry", *Japan Line,* 441 U.S., at 453, in international taxation. [. . .] Second, the tax here was imposed, not on a foreign entity as was

29. See Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions,* 10 L. & Policy Int. Bus. 409 (1979); Bischel 459-461, 464-466; B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 15.06 (4th ed. 1979); Harley, 143-160.

30. Another problem arises out of the treatment of inter-corporate dividends. Under formula apportionment as practiced by California, intercorporate dividends attributable to the unitary business are, like many other inter-corporate transactions, considered essentially irrelevant and are not included in taxable income. See n. 5 supra. If the arm's-length method were entirely consistent, it would tax inter-corporate dividends when they occur, just as all other investment income is taxed. (In which State that dividend could be taxed is not particularly important, since the issue here is international rather than interstate double taxation. See *Mobil,* 445 U.S., at 447-448.) It could also be argued that this would not, strictly speaking, result in double taxation, since the income taxed would be income "of" the parent rather than income "of" the subsidiary. The effect, however, would often be to penalize an enterprise simply because it has adopted a particular corporate structure. In practice, therefore, most jurisdictions allow for tax credits or outright exemptions for inter-corporate dividends among closely-tied corporations, and provision for such credits or exemptions is often included in tax treaties. See generally Model Treaty Art. 23; Bischel 2. No suggestion has been made here that appellant's dividends from its subsidiaries would have to be exempt entirely from domestic state taxation. And the grant of a credit, which is the approach taken by federal law, see 26 U.S.C. §§901 et seq., does not in fact entirely eliminate effective double taxation; the same income is still taxed twice, although the credit insures that the total tax is no greater than that which would be paid under the higher of the two tax rates involved. Moreover, once the Federal Government has allowed a credit for foreign taxes on a particular inter-corporate dividend, we are not persuaded why, as a logical matter, a State would have to grant another credit of its own, since the federal credit would have already vindicated the goal of not subjecting the taxpayer to a higher tax burden than it would have to bear if its subsidiary's income were not taxed abroad.

31. At the federal level, double taxation is sometimes mitigated by provisions in tax treaties providing for inter-governmental negotiations to resolve differences in the approaches of the respective taxing authorities. See generally Model Treaty Art. 25; 2 New York University Fortieth Annual Institute on Federal Taxation §31.03[2] (1982) (hereinafter N.Y.U. Institute). But cf. Owens, United States Income Tax Treaties: Their Role in Relieving Double Taxation, 17 Rutgers L. Rev. 428, 443-444 (role of such provisions procedural rather than substantive). California, however, is in no position to negotiate with foreign governments, and neither the tax treaties nor federal law provides a mechanism by which the Federal Government could negotiate double taxation arising out of state tax systems. In any event, such negotiations do not always occur, and when they do occur they do not always succeed.

the case in *Japan Line,* but on a domestic corporation. Although, California "counts" income arguably attributable to foreign corporations in calculating the taxable income of that domestic corporation, the legal incidence of the tax falls on the domestic corporation.[32] Third, even if foreign nations have a legitimate interest in reducing the tax burden of domestic corporations, the fact remains that appellant is without a doubt amenable to be taxed in California in one way or another, and that the amount of tax it pays is much more the function of California's tax rate than of its allocation method . Although a foreign nation might be more offended by what it considers unorthodox treatment of appellant than it would be if California simply raised its general tax rate to achieve the same economic result, we can only assume that the offense involved in either event would be attenuated at best.

A state tax may, of course, have foreign policy implications other than the threat of retaliation. We note, however, that in this case, unlike *Japan Line*, the Executive Branch has decided not to file an *amicus curiae* brief in opposition to the state tax.[33] The lack of such a submission is by no means dispositive. Nevertheless, when combined with all the other considerations we have discussed, it does suggest that the foreign policy of the United States – whose nuances, we must emphasize again, are much more the province of the Executive Branch and Congress than of this Court – is not seriously threatened by California's decision to apply the unitary business concept and formula apportionment in calculating appellant's taxable income.

(2)

When we turn to specific indications of congressional intent, appellant's position fares no better. First, there is no claim here that the federal tax statutes themselves provide the necessary pre-emptive force. Second, although the United States is a party to a great number of tax treaties that require the Federal Government to adopt some form of arm's-length analysis in taxing the domestic income of multinational enterprises,[34] that requirement is generally waived with respect to the taxes imposed by each of the contracting nations on its own domestic corporations.[35] This fact, if nothing else, confirms our view that such taxation is in reality of local rather than international concern. Third, none of the tax treaties into which the United States has entered covers the taxing activities of sub-national governmental units such as States,[36] and the Senate has on at least one occasion, in considering a proposed treaty, attached a reservation declining to give its consent to a provision in the treaty that would have extended the restriction against apportionment taxation to the States.[37] Finally, it remains true, as we said in *Mobil,* that "Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income". 445 U.S., at 448.[38] Thus, whether we apply the "explicit directive" standard articulated in *Mobil*, or some more relaxed standard which takes into account our residual concern about the foreign policy implications of California's tax, we cannot conclude that the California tax at issue here is preempted by federal law or fatally inconsistent with federal policy.

VI

The judgment of the California Court of Appeal is

Affirmed.

JUSTICE STEVENS took no part in the consideration or decision of this case.

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32. We recognize that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interests. We need not decide here whether such a case would require us to alter our analysis.
33. The Solicitor General did submit a brief opposing worldwide formula apportionment by a State in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.,* No. 81-349, a case that was argued last Term, and carried over to this Term. Although there is no need for us to speculate as to the reasons for the Solicitor General's decision not to submit a similar brief in this case, cf. Brief for National Governor's Association and the State of Hawaii as *Amicus Curiae* 6-7, there has been no indication that the position taken by the Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case.
34. See generally Model Treaty Art. 7(2); Bischel 33-38, 459-461.
35. See Model Treaty Art. 1(3); Bischel 718; N.Y.U. Institute §31.04[3].
36. See Bischel 7.
37. See 124 Cong. Rec. 18400; 19076 (1978).
38. There is now pending one such bill of which we are aware. See H.R. 2918, 98th Cong., 1st Sess. (1983).

In next issues:

U.S.A.: Unitary taxation – A dissenting opinion

Philippine Investment Policy Act of 1983
– by *Francisco G. Tegao*

U.K. versus unitary taxation – Statement before the
U.S. Treasury Working Group on Worldwide Unitary Taxation

U.S.A.: Foreign tax credit – Final IRS regulations

OECD: The taxation of income derived from the leasing of containers

Japan: Electronic industries versus unitary taxation

Guatemala: An overview of the 1983 tax reform
– by *M.A. García Caballero*

New Italian-United States Tax Treaty

A new tax treaty between Italy and the United States was initialled on 30 March 1983. The text of this treaty was printed in 54 *Diritto e Pratica Tributario* 4 (1983) at 1268. We gratefully acknowledge permission to reproduce the text in the *Bulletin for international fiscal documentation*. The treaty has not yet been signed and may be subject to changes.

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA
AND THE GOVERNMENT OF THE REPUBLIC OF ITALY FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND THE PREVENTION OF FRAUD OR FISCAL EVASION

The Government of the United States of America and the Government of the Republic of Italy, desiring to conclude a convention for the avoidance of double taxation with respect to taxes on income and the prevention of fraud or fiscal evasion, have agreed as follows:

Article 1
Personal scope

1. - Except as otherwise provided in this Convention, this Convention shall apply to persons who are residents of one or both of the Contracting States.

2. - Notwithstanding any provision of this Convention except paragraph 3 of this Article, a Contracting State may tax:
a) its residents (as determined under Article 4 (Resident)); and
b) its citizens by reason of citizenship
as if there were no convention between the Government of the United States of America and the Government of Italy for the avoidance of double taxation with respect to taxes on income and the prevention of fraud or fiscal evasion.

3. - The provisions of paragraph 2 shall not affect:
a) the benefits conferred by a Contracting State under paragraph 3 of Article 18 (Pensions, etc.), and under Articles 23 (Relief from Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and
b) the benefits conferred by a Contracting State under Articles 19 (Government Service), 20 (Professors and Teachers), 21 (Students and Trainees), and 27 (Diplomatic Agents and Consular Officials), upon individuals who are neither citizens of, nor have immigrant status in, that State.

Article 2
Taxes covered

1. - This Convention shall apply to taxes on income imposed on behalf of a Contracting State.

2. - The existing taxes to which this Convention shall apply are:
a) in the case of the United States: the Federal income taxes imposed by the Internal Revenue Code and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations, but excluding (notwithstanding paragraph 5 of Article 10 (Dividends)) the accumulated earnings tax and the personal holding company tax, (hereinafter referred to as "United States tax");
b) in the case of Italy:
i) the individual income tax (l'imposta sul reddito delle persone fisiche);
ii) the corporation income tax (l'imposta sul reddito delle persone giuridiche); and
iii) the local income tax (l'imposta locale sui redditi);
even if they are collected by withholding taxes at the source (hereinafter referred to as "Italian tax").

3. - The Convention shall apply also to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and shall notify each other of any significant official published material concerning the application of this Convention, including explanations, regulations, rulings, or judicial decision.

Article 3
General definitions

1. - For the purpose of this Convention, unless the context otherwise requires:
a) the term "person" includes an individual, a company, an estate, a trust, and any body of persons;
b) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;
c) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
d) the term "international traffic" means any transport by a ship or aircraft, except where such transport is solely between places in the other Contracting State;
e) the term "competent authority" means:
i) in the United States: the Secretary of the Treasury or his delegate; and
ii) in Italy: the Ministry of Finance;
f) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory.

Article 4
Resident

1. - For purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that:
a) this term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and
b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State, either in its hands or in the hands of its partners or beneficiaries.

2. - Where by reason of the provisions of paragraph I an individual is a resident of both Contracting States, then his status shall be determined as follows:
a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);
b) if the State in which he has his center of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. - Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavor to settle the question and to determine the mode of application of the Convention to such person.

Article 5
Permanent establishment

1. - For the purposes of this Convention, the term "permanent establishment" means a fixed place of business in which the business of the enterprise is wholly or partly carried on.

2. - The term "permanent establishment" shall include especially:
a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop;
f) a mine, quarry, or other place of extraction of natural resources; and
g) a building site or construction or assembly project which exists for more than twelve months.

3. - The term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise.

4. - A person acting in a Contracting State on behalf of an enterprise of the other Contracting State – other than an agent of an independent status to whom paragraph 5 applies – shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise.

5. - An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, where such persons are acting in the ordinary course of their business.

6. - The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6
Income from immovable property

1. - Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. - The term "immovable property" ("real property") shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, and rights to which the provisions of general law respecting landed property apply. Usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources shall also be considered immovable property; ships, boats, and aircraft shall not be regarded as immovable property.

3. - The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. - The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Article 7
Business profits

1. - The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. - Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment and other associated enterprises.

3. - In determining the profits of a permanent establishment, there shall be allowed as deductions expenses that are attributable to the activities of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. - No profits shall be attributable to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. - For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good sufficient reason to the contrary.

6. - Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 8
Shipping and air transport

1. - Profits of an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that State.

2. - The provisions of paragraph 1 shall also apply to profits derived from the participation in a pool, a joint business, or an international operating agency.

Article 9
Associated enterprises

Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State; or
b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Article 10
Dividends

1. - Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. - However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
a) (i) 5% of the gross amount of the dividends if the beneficial owner is a company which has owned 95% or more of the voting stock of the company paying the dividend for

a 12-month period ending on the date the dividend is declared; and
(ii) 10% of the gross amount of the dividends if the beneficial owner is a company which is not entitled to the benefits of clause (i) but which has owned 10% or more of the voting stock of the company paying the dividends for a 12-month period ending on the date the dividend is declared, provided that not more than 25% of the gross income of the company paying the dividends is derived from interest and dividends (other than interest derived in the conduct of a banking or financing business and interest or dividends received from subsidiary companies); and
b) 15% of the gross amount of the dividends in all other cases. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. - The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founder's shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. - The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case, the dividends are taxable in that other Contracting State according to its own laws.

5. - Where a company which is a resident of a Contracting State and not a resident of the other Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11
Interest

1. - Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. - However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interests is a resident of the other Contracting State, the tax so charged shall not exceed 15% of the gross amount of the interest.

3. - Notwithstanding paragraph 2, interest beneficially derived by
a) a Contracting State or an instrumentality wholly owned by that State;
or
b) a resident of a Contracting State with respect to debt obligations guaranteed or insured by that Contracting State or by an instrumentality wholly owned by that State
shall be exempt from tax by the other Contracting State.

4. - The term "interest" as used in this Article means income from Government securities, bonds, or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises.

5. - The provisions of paragraphs 1, 2, and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case, the interest is taxable in that other Contracting State according to its own laws.

6. - Interest shall be deemed to arise in a Contracting State when the payer is that State itself, a political or administrative subdivision, a local authority, or a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

7. - Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 12
Royalties

1. - Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. - However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed:
a) 5% of the gross amount of the royalties in respect of payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work;
b) 8% of the gross amount of the royalties in respect of payments of any kind received as a consideration for the use of, or the right to use, motion pictures and films, tapes or other means of reproduction used for radio or television broadcasting;
c) 10% of the gross amount of the royalties in all other cases.

3. - The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including motion pictures, films, tapes or other means of reproduction used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience.

4. - The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case, the royalties are taxable in that other Contracting State according to its own laws.

5. - Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political or administrative subdivision, a local authority, or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is

situated. Notwithstanding the preceding provisions of this paragraph, royalties with respect to the use of, or the right to use, rights or property within a Contracting State may be deemed to arise within that State.

6. - Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13
Capital gains

1. - Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 (Income from Immovable Property) and situated in the other Contracting State may be taxed in that other State.

2. - Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. - Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated by such enterprise in international traffic or of movable property pertaining to the operation of such ships or aircraft shall be taxable in that State.

4. - Gains from the alienation of any property other than that referred to in paragraphs 1, 2, and 3 shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14
Independent personal services

1. - Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State unless such services are performed in the other Contracting State and

a) the individual has a fixed base regularly available to him in that other State for the purpose of performing his activities, but only so much of the income as is attributable to that fixed base may be taxed in that other State; or

b) the individual is present in that other State for a period or periods aggregating more than 183 days in the fiscal year concerned.

2. - The term "personal services in an independent capacity" includes, but is not limited to, scientific, literary, artistic, educational and teaching activities as well as independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

Article 15
Dependent personal services

1. - Subject to the provisions of Articles 16 (Directors' Fees), 18 (Pensions, etc.) and 19 (Government Service), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. - Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned;

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. - Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment regularly exercised aboard a ship or aircraft operated by an enterprise of a Contracting State in international traffic shall be taxable only in that Contracting State.

Article 16
Directors' fees

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

Article 17
Artistes and athletes

1. - Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, if:

a) the amount of the gross receipts derived by such entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities exceeds twelve thousand United States dollars ($12,000) or its equivalent in Italian lire for the fiscal year concerned; or

b) such entertainer or athlete is present in that other State for a period or periods aggregating more than 90 days in the fiscal year concerned.

2. - Where income in respect of activities exercised by an entertainer or an athlete in his capacity as such accrues not to him but to another person, that income may, notwithstanding the provision of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. For purposes of the preceding sentence, income of an entertainer or athlete shall be deemed not to accrue to another person if it is proved by the entertainer or athlete that neither he nor persons related to him participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

Article 18
Pensions, etc.

1. - Subject to the provisions of paragraph 2 of Article 19 (Government Service), pensions and other similar remuneration beneficially derived by a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

2. - Annuities beneficially derived by a resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (in money or money's worth).

3. - Alimony and child support payments paid to a resident of a Contracting State by a resident of the other Contracting State shall be taxable only in the first-mentioned State. However, such payments shall not be taxable in either State if the person making such payments is not entitled to a deduction for such payments in the State of which he is a resident. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident. The term "child support" as used in this paragraph means periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce,

separate maintenance, or compulsory support.

Article 19
Government service

1. - a) Remuneration, other than a pension, paid by a Contracting State or a political or administrative subdivision or local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:
i) is a national of that State; or
ii) did not become a resident of that State solely for the purpose of rendering the services;
provided that the provisions of clause (ii) shall not apply to the spouse or dependent children of an individual who is receiving remuneration to which the provisions of subparagraph (a) apply and who does not come within the terms of clause (i) or (ii).

2. - a) Any pension paid by, or out of funds created by, a Contracting State or a political or administrative subdivision or local authority thereof to an individual in respect of services rendered to that State or subdivision or local authority shall be taxable only in that State.
b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident and a national of that State.

3. - The provisions of Article 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees), 17 (Artistes and Athletes), or 18 (Pensions, etc.), as the case may be, shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political or administrative subdivision or a local authority thereof.

Article 20
Professors and teachers

1. - A professor or teacher who makes a temporary visit to a Contracting State for the purpose of teaching or conducting research at a university, college, school, or other educational institution, or at a medical facility primarily funded from governmental sources, and who is, or immediately before such visit was, a resident of the other Contracting State shall, for a period not exceeding two years, be exempt from tax in the first-mentioned Contracting State in respect of remuneration from such teaching or research.

2. - This Article shall not apply to income from research if such research is undertaken not in the general interest but primarily for the private benefit of a specific person or persons.

Article 21
Students and trainees

Payments which a student or business apprentice (trainee) who is, or immediately before visiting a Contracting State was, a resident of the other Contracting State and who is present in the firstmentioned State exclusively for the purpose of his education or training receives for the purpose of his maintenance, education, or training shall not be taxed in that State provided that such payments arise outside that State.

Article 22
Other income

1. - Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. - The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6 (Income from Immovable Property), if the person deriving the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the items of income are taxable in the other Contracting State according to its own law.

Article 23
Relief from double taxation

1. - It is agreed that double taxation shall be avoided in accordance with the following paragraphs of this Article.

2. - In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof) the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income the appropriate amount of income tax paid to Italy; and in the case of a United States company owning at least ten percent of the voting stock of a company which is a resident of Italy from which it receives dividends in any taxable year, the United States shall allow as a credit against the United States tax on income the appropriate amount of income tax paid to Italy by that company with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to Italy, but shall not exceed the limitations of the law of the United States (for the purpose of limiting the credit to the United States tax on income from sources without the United States). For purposes of applying the United States credit in relation to tax paid to Italy, the taxes referred to in paragraphs 2(b) and 3 of Article 2 (Taxes Covered) shall be considered to be income taxes:
a) subject to the provisions of subparagraph (b), except for income or profits taxed by the United States solely by reason of citizenship in accordance with paragraph 2(b) of Article 1 (Personal Scope), income or profits derived by a resident of a Contracting State (who is not a resident of the other Contracting State) which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise in that other Contracting State; and
b) in the case of an individual who is a resident of Italy, income or profits which may be taxed by the United States by reason of citizenship in accordance with paragraph 2(b) of Article 1 (Personal Scope) shall be deemed to arise in Italy to the extent necessary to avoid double taxation, provided that in no event will the tax paid to the United States be less than the tax would be paid if the individual were not a citizen of the United States. The rules of this subparagraph with respect to the source of income shall not apply in determining credits against U.S. tax for foreign taxes other than the taxes referred to in paragraphs 2(b) and 3 of Article 2 (Taxes Covered).

*3. - *If a resident of Italy derives items of income which are taxable in the United States under the Convention (without regard to paragraph 2(b) of Article 1 (Personal Scope)), Italy may, in determining its income taxes specified in Article 2 of this Convention, include in the basis upon which such taxes are imposed the said items of income (unless specified provisions of this Convention otherwise provide). In such case, Italy shall deduct from the taxes so calculated the tax on income paid to the United States, but in an amount not exceeding the tax that would be due to the United States if the resident of Italy were not a citizen of the United States, and not exceeding that proportion of the aforesaid Italian tax which such items of income bear to the entire income. However, no deduction will be granted if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law. For purposes of applying the Italian credit in relation to tax paid to the United States the taxes referred to in paragraphs 2(a) and 3 of Article 2 (Taxes Covered) shall be considered to be income taxes.*

Article 24
Non-discrimination

1. - Nationals of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected there-

* This subsection was included in Art. 22 of the text of the treaty which we received. There was also a subsection 4 reading:
" 4. - For purposes of the United States obligation to avoid double taxation with respect to Italian tax under the preceding paragraphs of this Article:"
However, the text as it is printed here seemed to us to be more correct.

with, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1 (Personal Scope), also apply to persons who are not residents of one or both of the Contracting States. However, for purposes of United States taxation, United States citizens who are subject to tax on a worldwide basis are not in the same circumstances as Italian nationals who are not residents of the United States.

2. - The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. - Except where the provisions of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply, interest, royalties, and all other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

4. - Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State shall not be subjected in the firstmentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. - For purposes of this Article, this Convention shall apply to taxes of every kind and description imposed by a Contracting State or a political or administrative subdivision or local authority thereof.

Article 25
Mutual agreement procedure

1. - Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under Article 23 (Relief from Double Taxation) or paragraph 1 of Article 24 (Non-Discrimination), to the competent authority of the Contracting State of which he is a national.

2. - The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation which is not in accordance with the Convention.

3. - The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.

4. - The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

Article 26
Exchange of information

1. - The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention, and for the prevention of fraud or fiscal evasion. The exchange of information is not restricted by Article 1 (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. - In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:
a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

Article 27
Diplomatic agents and consular officials

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officials under the general rules of international law or under the provisions of special agreements.

Article 28
Entry into force

1. - This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State and instruments of ratification shall be exchanged as soon as possible.

2. - The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
a) in respect of tax withheld at the source, for amounts paid or credited on or after the first day of the second month following the date on which this Convention enters into force,
b) in respect of other taxes, for taxable periods beginning on or after the first day of the second month following the date on which this Convention enters into force.

3. - Subject to the provisions of paragraph 4, the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Washington March 30, 1955, and the exchange of letters concerning the application of the Convention of March 30, 1955, for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, exchanged at Rome December 13, 1974, are terminated. Their provisions shall cease to have effect for taxes for which the provisions of this Convention have effect in accordance with paragraph 2.

4. - Where any greater relief from tax would have been afforded by any provision of the 1955 Convention than under this Convention, any such provision shall continue to have effect for the first taxable year with respect to which the provisions of this Convention have effect under paragraph 2.

5. - The arrangement between the United States and Italy providing for relief from double income taxation on shipping profits effected by exchange of notes dated March 10, 1926, and May 5, 1926, is terminated.

Article 29
Termination

This Convention shall remain in force until terminated by one of the Contracting States. Either Contracting State may terminate the Convention at any time after 5 years from the date on which this Convention enters into force provided that at least 6 month's prior notice of termination has been given through diplomatic channels. In such event, the Convention shall cease to have effect:
a) in respect of tax withheld at the source, for amounts paid or credited on or after the first day of January next following the expiration of the 6 months period;
b) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the expiration of the 6 months period.

Done at . . . in duplicate, in the English and Italian languages, the two texts having equal authenticity, this . . . day of . . . , 19 . . .
For the United States of America.
For the Republic of Italy.

Protocol

The Government of the United States of America and the Government of the Republic of Italy, desiring to conclude a Protocol clarifying and supplementing the Convention for the avoidance of double taxation with respect to taxes on income and the prevention of fraud or fiscal evasion to be signed simultaneously with the signing of this Protocol, have agreed upon the the following provisions.

Article 1

1. - For purposes of paragraph 2(b) of Article 1 (Personal Scope) of the Convention, the term "citizen" as applied to the United States shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

2. - The provisions of paragraph 2 of Article 1 (Personal Scope) of the Convention shall not affect the benefits conferred by a Contracting State under paragraph 14 of Article 1 and under Article 4 of this Protocol.

3. - For purposes of paragraph 2(a) of Article 2 (Taxes Covered) of the Convention, the Convention shall apply to the excise tax imposed by the United States on insurance premiums paid to foreign insurers only to the extent that the foreign insurer does not reinsure such risks with a person not entitled to exemption from such tax under this or any other Convention.

4. - For purposes of paragraph 2 of Article 5 (Permanent Establishment) of the Convention, a drilling rig or ship used for the exploration or development of natural resources constitutes a permanent establishment in a Contracting State only if it remains in that State for more than 120 days in a twelve month period.

5. - For purposes of paragraph 1 of Article 8 (Shipping and Air Transport) of the Convention, profits from the operation in international traffic of ships or aircraft include:
a) profits from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport in international traffic of goods or merchandise ; and
b) profits derived from the rental on a full basis of ships or aircraft and profits derived from the rental on a bareboat basis of ships or aircraft, provided in the latter case that such rental profits are incidental to other profits from the operation of ships or aircraft in international traffic.

6. - For purposes of Article 8 (Shipping and Air Transport) of the Convention, and notwithstanding any other provision of the Convention, profits which a national of the United States not resident in Italy or a United States corporation derives from operating ships documented on aircraft registered under the laws of the United States shall be exempt from tax in Italy.

7. - If, in accordance with Article 9 (Associated Enterprises), of the Convention, a redetermination has been made by one Contracting State with respect to a person, the other Contracting State shall, to the extent it agrees that such redetermination reflects arrangements or conditions which would be made between independent persons, make the corresponding adjustments with respect to persons who are related to such person and are subject to the taxing jurisdiction of that other State. Any such adjustment shall be made only in accordance with the mutual agreement procedure in Article 25 (Mutual Agreement Procedure) of the Convention and with paragraph 15 of Article 1 of this Protocol.

8. - The provisions of Article 9 (Associated Enterprises) of the Convention shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

9. - For purposes of paragraph 2(a) of Article 10 (Dividends), the term "subsidiary company" means a corporation in which the company paying the dividends owns more than 50% of the voting stock.

10. - Notwithstanding paragraph 2 of Article 12 (Royalties) of the Convention, in the case of royalties derived with respect to taxable personal (movable) property, the tax imposed by the Contracting State in which such royalties arise may not exceed 7% of the gross amount of such royalties.

11. - For purposes of paragraph 1 of Article 13 (Capital Gains) of the Convention:
a) the term "immovable property" in the case of the United States includes a United States real property interest; and
b) the term "immovable property" in the case of Italy includes:
i) immovable property referred to in Article 6;
ii) shares or comparable interest in a company or other body of persons, the assets of which consist wholly or principally of real property situated in Italy; and
iii) an interest in an estate of a deceased individual, the assets of which consist wholly or principally of real property situated in Italy.
c) property described in subparagraph a) of this paragraph shall be deemed to be situated in the United States and property described in subparagraph b) of this paragraph shall be deemed to be situated in Italy.

12. - For purposes of paragraph 3 of Article 13 (Capital Gains) of the Convention, gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated by such enterprise in international traffic include:
a) gains from the alienation of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport in international traffic of goods or merchandise; and
b) gains from the alienation of ships or aircraft rented on a full basis or gains from the alienation of ships or aircraft rented on a bareboat basis if, in the latter case, rental profits were incidental to other profits from the operation of ships or aircraft in international traffic.

13. - Directors' fees and other similar payments derived by a resident of a Contracting State which are described in Article 16 (Directors' Fees) of the Convention may be taxed in the other Contracting State only to the extent that the fees and other payments are attributable to services performed in such other State.

14. - With respect to Article 18 (Pensions, etc.) of the Convention, it is agreed that social security payments and similar public pensions not covered by Article 19 (Government Service) of the Convention paid by a Contracting State to an individual who is a resident of the other Contracting State may be taxed in each Contracting State, but only to the extent of 50% of such payments in the fiscal year.

15. - With respect to Article 25 (Mutual Agreement Procedure) of the Convention, it is understood that an adjustment of taxes pursuant to that Article may be made only prior to the final determination of such taxes. It is further understood that, in the case of Italy, the preceding sentence means that invoking the mutual agreement procedure does not relieve a taxpayer of the obligation to initiate the procedures of domestic law for resolving tax disputes.

16. - For purposes of Article 26 (Exchange of Information) of the Convention, the Convention shall apply to taxes of every kind imposed by a Contracting State, but only insofar as the information is relevant to the assessment of taxes covered by Article 12 (Taxes Covered) of the Convention. It is understood that appropriate United States Congressional Committees and the General Accounting Office shall be afforded access to the information exchanged under the Convention where such access is necessary to carry out their oversight responsibilities, subject only to the limitations and procedures of the Internal Revenue Code.

Article 2

1. - A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to the benefits provided in Articles 7 (Business Profits), 10 (Dividends), 11 (Interest), 12 (Royal-

ties), 13 (Capital Gains) or 22 (Other Income) unless

a) more than 50% of the beneficial ownership of such person (or in the case of a company, more than 50% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:

i) individuals who are residents of the United States;

ii) citizens of the United States;

iii) individuals who are residents of Italy;

iv) companies as described in subparagraph b); or

v) the Contracting States; or

b) it is a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange.

2. - Paragraph 1 shall not apply unless the competent authority of the other Contracting State determines that either the establishment, acquisition or maintenance of such person or the conduct of its operations had as a principal purpose obtaining benefits under the Convention.

3. - For the purpose of subparagraph (1)(b), the term "a recognized stock exchange" means:

a) the Nasdao System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934.

b) any stock exchange constituted and organized according to Italian laws; and

c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

Article 3

The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded

a) by the laws of either Contracting State, or

b) by any other agreement between the Contracting States.

Article 4

It is agreed that a United States citizen resident in Italy who is a partner of a partnership that is a national of the United States shall be entitled to a refundable credit against that partner's individual income tax (l'imposta sul reddito delle persone fisiche) imposed by Italy for the fiscal year equal to the portion of the corporation income tax (l'imposta sul reddito delle persone giuridiche) imposed by Italy for that year on the partnership that is attributable to that partner's share of the partnership income.

Article 5

Taxes withheld at the source in a Contracting State at the rates provided by domestic law will be refunded by request of the taxpayer if the right to collect the said taxes is limited by the provisions of the Convention. Claims for refund, which shall be made within the time fixed by the law of the Contracting State which is obliged to make the refund, shall be accompanied by an official certificate of the Contracting State of which the taxpayer is a resident certifying the existence of the conditions required for being entitled to the benefits provided for by the Convention. This provision shall not be construed to prevent the competent authority of each Contracting State from establishing other modes of application of the benefits provided for by the Convention.

Article 6

Each of the Contracting States may collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by such other State does not enure to the benefit of persons not entitled thereto. The preceding sentence shall not, however, impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own tax, or which would be contrary to its sovereignity, security, or public policy.

Article 7

1. - This Protocol shall be subject to ratification in accordance with the applicable procedures of each Contracting State, and instruments of ratification shall be exchanged at . . .

2. - The Protocol shall enter into force upon the exchange of instruments of ratification and shall thereafter have effect in accordance with Article 28 of the Convention.

Article 8

This Protocol shall remain in force as long as the Convention between the United States of America and Italy for the avoidance of double taxation with respect to taxes on income and the prevention of fraud or fiscal evasion of this date shall remain in force.

Done at . . . in duplicate, in the English and Italian languages, the two texts having equal authenticity, this day of . . ., 19 . . .

Exchange of notes

Letter from the Italian representative

Excellency

I have the honour to refer to the Convention and Protocol between Italy and the United States of America for the avoidance of double taxation with respect to taxes on income and the prevention of fraud or fiscal evasion, signed today at . . . and I should like to state on behalf of the Government of the Republic of Italy our understanding with respect to an important unresolved issue. It is the position of the Government of Italy that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of Italian companies results in inequitable taxation and imposes excessive administrative burdens on Italian companies doing business in those states. Under that method, the profit of an Italian company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the Italian company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies. For an Italian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a United States state in English imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was rejected by the Senate. The Government of Italy continues to be concerned about this issue as it affects Italian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Italy on this subject.

It is further understood that if any State or locality of the United States imposes tax on profits of enterprises of Italy from the operation in international traffic of ships or aircraft, Italy may impose its local income tax (ilor) on such profits of enterprises of the United States, notwithstanding subparagraph 2(b)(iii) of Article 2 (Taxes Covered) and Article 8 (Shipping and Air Transport).

I have furthermore the honour to propose that the present Note and Your Excellency's reply confirming the acceptance by the Government of the United States of America of the above proposals shall be regarded as constituting an agreement between the two Governments concerning the matters above mentioned.

I avail myself of this opportunity to extend to Your Excellency the assurance of my highest consideration.

Letter from the U.S. representative

Excellency

I have the honour to acknowledge receipt of your letter of today's date which reads as follows:

[See above]

I have the honour to inform you that the Government of the United States of America is in agreement with the above proposals.

I avail myself of this opportunity to extend to Your Excellency the assurance of my highest consideration.

MALAYSIA:

Managers' Fees not Taxable under Malaysia-United Kingdom Treaty

By Jap Kim Siong

In the event of any inconsistency between the provisions of Malaysian income tax law and a double taxation treaty the treaty prevails. Royalty versus income or profit – paid by a company in Malaysia to a U.K. company not having a permanent establishment in Malaysia – is only taxable in the U.K.

THE FACTS

Company A was incorporated in the United Kingdom and, for purposes of Malaysian income tax, was resident in the United Kingdom. It had no permanent establishment in Malaysia. On 9 May 1973 it entered into an Agreement with Malaysian company B to set up company C in Malaysia with its registered office in Penang for the purpose of manufacturing catheters. This Agreement provided, inter alia, that A would appoint 3 directors to the board of C. These directors and employees of A provided managerial, planning, training, technical, operational, marketing and development services to C. The result was that C paid to A in the United Kingdom the following amounts as managerial fees:

Period	*Amount (M$)*
From 1 June 1973 to 31 December 1983	35,217
assessment year 1974	56,134
assessment year 1975	49,152

The Malaysian tax authorities treated these managerial fees as royalties within the definition of Section 2 of the Income Tax Act, 1967 (hereinafter "Act") and accordingly made assessments on A considering the royalties to be derived from a source in Malaysia. A challenged these assessments because it found that these payments were not royalties under the definition provided in the income tax treaty between the United Kingdom and Malaysia signed on 30 March 1973 (hereinafter "Treaty"). A argued that under the Treaty provisions these payments must be taxed only in the United Kingdom since A does not carry on a business in Malaysia through a permanent establishment situated therein.

THE ISSUE

The issue was:

- were the fees paid taxable in Malaysia under the Act as royalties, or
- were they business income as defined in the Treaty and, lacking a permanent establishment in that country, not subject to Malaysian income tax?

For this purpose the courts also had to decide whether Treaty provisions prevail over domestic law.

THE LAW

Domestic law

The Act defines the term "royalty" in Section 2 as follows:

"royalty" includes-
(a) any sums paid as consideration for the use of, or the right to use-
(i) copyright, artistic or scientific works, patents, designs or models, plans, secret processes or formulae, trademarks or tapes for radio or television broadcasting or other like property or rights;
(ii) know-how or information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
(b) income derived from the alienation of any property, know-how or information mentioned in paragraph (a) of this definition;
(c) amounts paid in consideration of services rendered 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 plant, machinery or other apparatus purchased from, such non-resident person; and
(d) any other amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme . . .

Treaty law

Article XI, paragraph 3 of the Treaty defines the term "royalty" as:

The term "royalties" as used in this Article means a payment of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, any patent, trademark, design or model, plan, secret formula or process or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience. The term, however, does not include any royalty or other amount paid in respect of motion picture films or of tapes for radio or television broadcasting, or of the operation of a mine, oil well, quarry or any other place of extraction of natural resources or of timber or forest produce. The term "approved industrial royalties" as used in this Article means royalties as defined in this paragraph which are approved and certified by the competent authority of Malaysia as payable for the purpose of promoting industrial development in Malaysia and which are payable by an enterprise which is wholly or mainly engaged in activities falling within one of the following classes:
(a) manufacturing, assembling or processing;
(b) construction, civil engineering or shipbuilding; or
(c) electricity, hydraulic power, gas or water supply.

Mr. K.S. Jap is principal research associate at the International Bureau of Fiscal Documentation, Amsterdam.

THE DECISION OF THE HIGH COURT AT KUALA LUMPUR

(Tax Appeal No. 1 of 1978)

The High Court held that the payments were management fees paid to a company resident in the United Kingdom not having a permanent establishment in Malaysia. It was asserted that the sums paid were royalties within the definition of Section 2 of the Act, as amended by the Income Tax (Amendment) Act 1973 (Act A 158) on 1 March 1973, effective for the year of assessment 1973 and subsequent years, but were not so within the definition of paragraph 3 of Article XI of the Treaty which came into force on 25 July 1973. Whatever the sequence of the coming into force of Section 2 of the Act and the Treaty, by virtue of Section 132(1) of the Act it was obvious that the provisions of the Treaty override those of the Act in favor of its beneficiaries. The High Court Judge did not think it could be disputed that the payments to A were in fact income for the management services A provided to C in compliance with their Agreement.

Section 132(1) of the Act reads as follows:

If the Minister by statutory order declares that
(a) arrangements specified in the order have been made by the Government of any territory outside Malaysia with a view to according relief to double taxation in relation to tax under this Act and any foreign tax of that territory; and
(b) it is expedient that those arrangements should have effect then, so long as the order remains in force, those arrangements shall have effect in relation to tax under this Act notwithstanding anything in any written law.

Article VI of the Treaty provides, as far as of importance in this connection:

(1) The income or profits of an enterprise of one of the Contracting States shall be taxable only in that Contracting State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, tax may be imposed in that other Contracting State on the income or profits of the enterprise but only on so much thereof as is attributable to that permanent establishment . . .
(5) Where income or profits include any item of profits which is dealt with separately in another Article of this Agreement, the provisions of that other Article shall not be affected by the provisions of this Article.

Since the definition of "royalties" in Article XI of the Treaty did not apply, it was clear that by virtue of paragraph 1 of Article VI of the Treaty any income of A was taxable only in the United Kingdom since A did not carry on business in Malaysia through a permanent establishment situated therein. As the provisions of the Treaty bore no ambiguity, the High Court Judge did not consider it appropriate to call in aid the extraneous, presumptive deeming source of income in Malaysia under the provisions of Section 15(b) of the Act (entitled "Derivation of interest and royalty income in certain cases"), without which, it seemed to the High Court Judge, the tax authorities would not have been able to charge tax on this income of A under the charging provisions of the Act. Therefore, the High Court ruled that the decision of the Special Commissioners of Income Tax confirming the assessment made by the Commissioner of Income Tax was wrong in law.

THE DECISION OF THE FEDERAL COURT AT KUALA LUMPUR

(Federal Court Civil Appeal No. 17 of 1981)

The Federal Court of Appeal of Malaysia confirmed the reasoning by the High Court as set out above.

Cases referred to:
(1) Ostime (H.M. Inspector of Taxes) v. Australian Mutual Provident Society (38 Tax Cases 492 at 509).
(2) Director-General of Inland Revenue v. Phaltan Sugar Works Ltd. (1983 1 M.L.J. 74).

COMMENT

1. Appeal against the assessment may be made by the assessee, if he is dissatisfied with the assessment made by the Commissioner of Income Tax. If the assessee is dissatisfied with the decision of the Commissioners an appeal before the Special Commissioner of Income Tax may be made.

   An appeal on a question of law may be made to the High Court of Malaysia. Further appeals may be made by either party (i.e. the Director General of Inland Revenue or the taxpayer) to the Special Commissioner, then to the Federal Court of Malaysia and, ultimately, to the Privy Council in the United Kingdom.

   The Editors do not know whether in this case an appeal by the tax authorities was lodged with the Privy Council. However, if so, it may well be believed that the Council would confirm the decisions by the Courts in Malaysia.

2. The Finance Bill 1983 contains 1984 Budget tax proposals presented by the Minister of Finance to Parliament on 21 October 1983. One of the proposals is the introduction of a new Section 4A in the Act with respect to "special classes of income" derived by non-residents of Malaysia. Those "special classes of income" are:
   (a) amounts paid in consideration of services rendered by the person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from, such person;
   (b) amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme; or
   (c) rent or other payments made under any agreement or arrangement for the use of any movable property.

Concurrent to the aforesaid amendment, the definition of "royalty" in Section 2 of the Act is amended so that income falling under (a) and (b) above no longer constitutes "royalty" with effect as of 21 October 1983 but will then be treated as "special classes of income". Those "special classes of income" will be subject to a withholding tax of 15% on the gross income by a new Section 109 B of the Act, as royalties now are.

The implication of the introduction of Section 4A with respect to "special business income" of the nature mentioned under (a) and (b) above and derived by non-residents of Malaysia is that if they were formerly taxable on a net basis at a rate of 45 or 50% (income tax, development tax, excess profits tax) under Section 4(a) of the Act, they then will be taxable on a gross basis at a rate of 15% under Section 4A of the Act.

By reclassifying income mentioned under (a) and (b) above as "special income" instead of "royalty", it may be asserted that the decision in the present case would not be otherwise, except that the tax treatment of the aforementioned income would be no longer "royalty" but "special business income" under the Act and under Article VI of the Treaty.

CONFERENCE DIARY

MARCH 1984

Management Centre Europe: Franchising (including: franchising abroad: money and taxation). London (United Kingdom), 7-9 March (English).

International Tax Planning Association: Guernsey Seminar. St. Peter Port (Guernsey) (Channel Islands), 8 and 9 March (English).

Management Centre Europe: Leasing (including: taxation and leasing; taxation and leasing-cross-border considerations). Brussels (Belgium), 12-15 March (English).

Dr. Peter Deubner Verlag GmbH: Tax beneficial investment. (Special seminar). Munich, 14 March; Frankfurt, 15 March; Cologne, 16 March (Federal Republic of Germany) (English).

Seminar Services S.A.: How to set-up and operate holding and finance companies (Netherlands, Luxembourg, Netherlands Antilles, Channel Islands, Switzerland) (including: tax treaties and tax planning). Amsterdam (Netherlands), March 13 and 14 (English).

APRIL 1984

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: Taxation of enterprises (Seminar). St. Gallen (Switzerland), 4-6 April (German).

Management Centre Europe: International Business Tax Conference (including: tax planning, including transfer pricing). Vienna (Austria), 25-27 April (English).

MAY 1984

International Tax Planning Association: 10th Annual Conference. Munich (Federal Republic of Germany), 16-18 May (English).

SEPTEMBER 1984

International Bar Association: Twentieth Biennial Conference (including: measures against treaty shopping; important new developments in national tax legislation as well as current activities of international organisations in the tax field; residence and transfer of residence of bodies corporate). Vienna (Austria), September 2-7 (English).

International Tax Planning Association: Monte Carlo Workshop. Monte Carlo (France), 13 and 14 September (English).

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina). 16-21 September (English, French, German, Spanish).

NOVEMBER 1984

International Tax Planning Association: Hong Kong Seminar. Hong Kong, 26 and 27 November (English).

FOR FURTHER INFORMATION PLEASE WRITE TO:

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

Business Perspectives: Suite 804, 1735 Eye Street, N.W., Washington, D.C. 20006 (U.S.A.).

International Bar Association: 2 Harewood Place, Hanover Square, London W1R 9HB (United Kingdom).

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

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

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

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

Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41 (Federal Republic of Germany).

Seminar Services S.A.: Chemin Ste-Agnès, 8 CH-1700 Fribourg (Switzerland).

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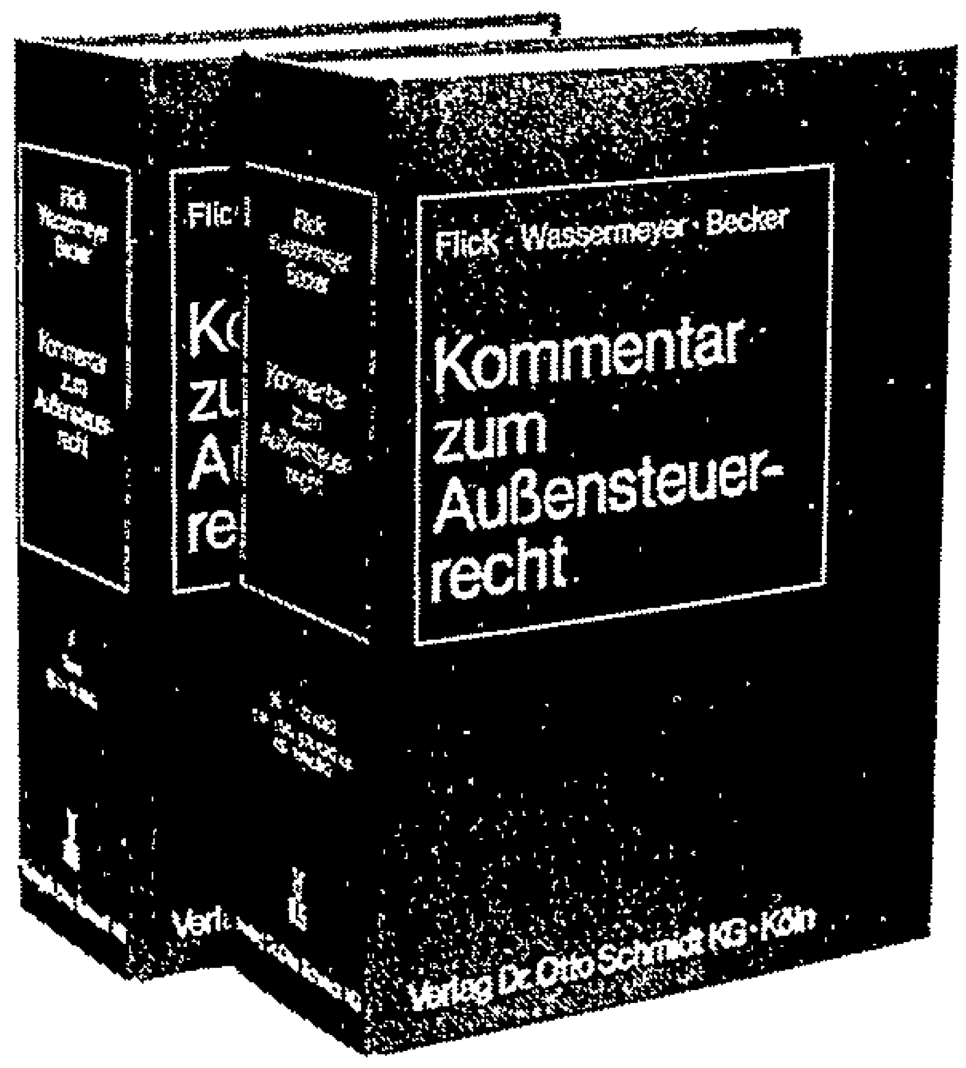

Flick Wassermeyer Becker

Kommentar zum Außensteuer-recht

Zehn Jahre nach Inkrafttreten des Außensteuerreformgesetzes liegt nunmehr aufgrund weiterer starker Nachfrage die 4. Auflage dieses großangelegten Kommentars vor. Die Autoren, die als Spezialisten des internationalen Steuerrechts bekannt sind, erläutern die auch dem Fachmann nicht leicht verständlichen Vorschriften des Außensteuerrechts ganz aus der Sicht der Wirtschaftspraxis. Anschauliche Übersichten, zahlreiche Beispiele und ein ausführliches Sachregister erleichtern den Zugang zu dieser schwierigen Materie.

Schon kurze Zeit nach Verabschiedung der **Verwaltungsgrundsätze zur Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen** bringen die Verfasser in der 16. Lieferung, die in der 4. Auflage bereits enthalten ist, eine sorgfältige, 218 Seiten umfassende Kommentierung jeder einzelnen Vorschrift. Dabei wird gleichzeitig auch auf die jeweilige Regelung in den US regulations zu sec. 482 und im OECD-Bericht zu den Transferpreisen hingewiesen. Diese kritische Stellungnahme ist für den Praktiker von großer Bedeutung, zumal die Finanzverwaltung nur eine Übergangsfrist von 3 Jahren eingeräumt hat.

„... Das vorliegende Werk besticht durch eine klare und systematische Darstellung. ... insgesamt stellt der Kommentar von Flick/Wassermeyer/Becker ein ganz hervorragendes Werk dar, ohne das Theorie und Praxis nicht auskommen werden."
Wp. und Stb. Gerhard Haas in „Die steuerliche Betriebsprüfung"

Vorzüge, die den Flick/Wassermeyer/Becker zu der Autorität im Außensteuerrecht werden ließen:

Gründliche, umfassende und systemgerechte Kommentierung ganz aus der Sicht der Wirtschaftspraxis;

✻

Trotz der schwierigen Materie verständliche Darstellung in klarer, prägnanter Sprache.

✻

Langjährige Praxis der Autoren im internationalen Steuerrecht.

✻

Viele praktische Beispiele und Merksätze.

✻

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Ausführliche Kommentierung der „Verwaltungsgrundsätze".

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Außensteuergesetz. Anrechnung ausländischer Steuern (§§ 34c, 34d EStG, 26 KStG) und nationale Schachtelprivilegien (§§ 9 Nr. 7 und 12 Abs. 3 Nr. 4 GewStG, 102 Abs. 2 BewG). Auslandsinvestitionsgesetz. Entwicklungsländer-Steuergesetz.

*Von Rechtsanwalt **Dr. Hans Flick,** Fachanwalt für Steuerrecht; Richter am FG **Dr. Franz Wassermeyer,** Lehrbeauftragter an der Universität Bonn; Rechtsanwalt **Helmut Becker,** Fachanwalt für Steuerrecht.*

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CANADA - IVORY COAST

Tax treaty concluded

By Servaas van Thiel

Mr. Van Thiel is reseach associate at the International Bureau of Fiscal Documentation.

On 16 June 1983, Canada and the Ivory Coast signed a Convention for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fiscal Evasion (hereinafter "Convention").[1] The text of the Convention is patterned on the 1977 OECD Model Convention (hereinafter "Model"); however, there are deviations which will be discussed briefly. Some of the deviations are inspired by the United Nations Model Double Taxation Convention between Developed and Developing Countries (hereinafter "UN Model").

Taxes covered (Art. 2)

The Convention does not cover taxes on capital as such. Accordingly, Art. 2 differs from the Model and there is no article comparable to Art. 22 of the Model which attributes the right to tax the value of immovable property, movable property, ships and aircraft and other elements of capital.

There is also no mention of taxes imposed by political subdivisions or local authorities; however, Canadian taxpayers do get unilateral relief for certain taxes imposed by political subdivisions of other countries under Para. 126 (7) (a) of the Canadian Income Tax Law.

Definitions

The definitions of the words "person" and "company" are slightly broader than in the Model because the Convention includes, in the case of Canada, an estate and a trust as a person and – in French – a "société" as a corporation.

The definition of the word "resident" reproduces Art. 4 of the Model with one substantive change, namely, the deletion of the sentence: "But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein." This deletion is in line with the observation[2] of the group which drafted the UN Model, that the sentence could have a very broad impact. For instance, if a Contracting State only taxes domestic-source income, this sentence might result in all residents of that country being characterized as non-residents, thereby depriving the Contracting State of its tax jurisdiction. Neither Canada nor the Ivory Coast taxes domestic-source income only, but nevertheless the sentence has been deleted. In order to provide for the special situation of diplomats, Art. 25 contains an extra provision.

Although the definition of permanent establishment is identical to the Model, the enumeration of what should be included in and excluded from the concept differs substantially.

Contrary to the Model, the Convention includes:
- a store;
- a building site, or construction or temporary assembly project, or supervisory activities in connection therewith, if these continue for more than 6 months, which is the period mentioned in the UN Model (rather than 12 months). When such a temporary project is connected with the sale of machinery or equipment it is deemed to be a permanent establishment, even if it continues for less than 6 months, provided that the charges payable for the project or activity exceed 10% of the sale price of the machinery or equipment;
- a fixed place of business used for the purpose of purchasing or delivering goods or for collecting information, if that is the object of the business, as well as a stock of goods maintained for the purpose of delivery. The Model excludes the use of facilities or maintenance of a stock for the purpose of delivery.

Excluded from the definition of permanent establishment are the maintenance of a fixed place of business solely for the purpose of collecting information (if that is not the actual object of the enterprise) or for the purpose of advertising, furnishing information, scientific research or similar activities of a preparatory character.

Under the Convention, as in the Model, an enterprise that carries on a business through an independent agent shall not be deemed to have a permanent establishment. However, when the activities of such an agent are devoted almost wholly to the business of that enterprise, he shall not be considered an independent agent. This addition follows the UN Model.

A final difference between the Model and the Convention concerns the taxation of insurance profits. The Convention, like the UN Model, attributes tax jurisdiction of insurance profits to the country where the premiums are paid. An insurance enterprise of one Contracting State is deemed to have a permanent establishment in the other Contracting State if it collects premiums there.

Business profits (Art. 7)

The Convention slightly differs from the Model by deleting the provision that no profits shall be attributed to a permanent establishment by reason of the mere purchase of goods for the enterprise. Through this deletion the tax jurisdiction of the source country is extended. Further extensions as proposed in the UN Model, however, are not incorporated in the Convention. For instance, the "force of attraction" rule, according to which the source country can tax sales similar to those made by the permanent establishment, even if they are not con-

1. Convention between the Government of Canada and the Government of the Republic of the Ivory Coast for the Avoidance of Double Taxation with Respect to Taxes on Income and Prevention of Fiscal Evasion, *Canada's Tax Treaties*, Vol. II, A.B. McKie Butterworths, Toronto, at 14,747.
2. *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, United Nations Publication ST/ESA/102, Sales No. E.80.xvi.3, New York 1980, at 54.

ducted through the permanent establishment, is absent.[3].

Income from shipping and air transport (Art. 8)

The Model clause is reproduced. However, it is expressly stated that profits from domestic transport may be taxed in the Contracting State in which the transport takes place. Furthermore a special provision concerning the company "Air Afrique"[4] is included restricting the applicability of the provision only to that part of the profits accruing, in accordance with the statutes of the company, to the Ivory Coast. No provisions, as in the alternative version of Art. 8 in the UN Model, are made whereby profits arising from more than casual shipping activities in the source country can be taxed in that country, on the basis of an appropriate allocation.[5]

Associated enterprises (Art. 9)

Although the Convention provides for adjustment of non-arm's length transactions between associated enterprises in the same way as the Model, it differs in setting time limits. In general, adjustment shall not take place after the expiry of time limits provided in national laws, with a maximum of 5 years from the end of the year in which the profits would have accrued to the enterprise of the adjusting State. Time limits do not apply in the case of fraud, wilful default or neglect.

It is noted that the Convention also adopts paragraph 2 of the Model, thus including the requirement that if one of the Contracting States includes profits in its tax computation which have already been taxed in the other State, that other State will make the appropriate adjustment, if necessary, after consultation by the competent authorities.

Dividends (Art. 10)

Dividends may generally be taxed in the country of residence of the recipient; however, the source country may also impose tax which may not exceed 18% on the gross amount of dividends paid by a company resident in the Ivory Coast which is exempt from tax on profits and a tax of 15% on the gross amount of the dividends in all other cases.

In addition, Canada and the Ivory Coast may continue to impose their substitute dividend withholding tax on branch profits of non-resident companies, but at a rate which may not exceed 15%.

Interest (Art. 11)

Like the Model, the Convention attributes the primary right to tax interest to the State of the creditor. The State of the debtor may also impose a tax not exceeding 15% of the gross amount of interest. However, interest paid to the Government (including subdivisions or government agencies) is exempt from source taxation. This exemption would, inter alia, apply to interest on loans made by the Canadian Export Development Corporation (not loans guaranteed or insured by this Corporation). The term "interest" as used in the Convention differs slightly from the Model. It includes income that according to the national tax law of the source country is assimilated to income from money lent. It does not expressly exclude penalty charges for late payments.

Royalties (Art. 12)

Whereas the Model attributes tax jurisdiction of royalties to the Contracting State where the beneficial owner/recipient is resident, the Convention, following the UN Model, provides that royalties may also be taxed in the State in which they arise. The tax thus imposed may not exceed 10%. This provision takes into account the actual situation that patents are usually licensed from developed to developing countries and not vice versa, so that royalties usually arise in the latter. The definition of royalties is roughly the same as in the Model.[6] The definition of the source of royalties, however, follows the suggestion of the UN Model. In principle, royalties are deemed to arise in the State where the payor is resident. However, if the payor has a permanent establishment or fixed base in one of the Contracting States:

- in connection with which the liability to pay the royalties was incurred; and
- which bears the royalties;

then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Capital gains (Art. 13)

The Article on capital gains includes a paragraph – paragraph 4 – common to Canadian tax treaties and the UN Model, determining that gains from the alienation of shares in a company or interests in a partnership, trust or estate, the property of which consists principally of immovable property situated in a Contracting State, may be taxed in that State. This difference from the Model is in accordance with the Canadian reservation to Article 13.[7] Another new paragraph concerns the taxation of capital gains of former residents. A Contracting State can tax capital gains derived by individuals resident in

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3. UN Model, Art. 7 reads: "If the enterprise carries on business as aforesaid [i.e. through a permanent establishment], the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to:
a) that permanent establishment [like the Model];
b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or
c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment."

4. Air Afrique is a multinational company in which various Western African States participate.

5. UN Model, Art. 8 B (alternative B), section 2. "More than casual" is explained as meaning a scheduled or planned visit of a ship to a particular country to pick up freight or passengers. UN Model, note 3, at 102.

6. Contrary to the Model, the Convention includes films and tapes for television and radio broadcasting.
Under subpara. 212(1) (d) (VI) of the Canadian Income Tax Law a payment on or in respect of a copyright in respect of the production or reproduction of any literary, dramatic, musical or artistic work is excluded from the definition of royalties to which a 25% withholding tax applies. W.A. Macdonald, QC, *Income Taxation in Canada,* Prentice Hall, Ontario, Vol. 5 at 100, 924.

7. See "Comment on the Model", Art. 13, Para. 34.

the other State if the individual has, during the 6 years preceding the alienation, been resident in the first State.

Independent personal services (Art. 14)

Like the Model, the Convention attributes tax jurisdiction on income from professional services to the State of residence unless the resident has a fixed base in the other State. But added to this exception is a second one, which gives the source country the right to tax as well when such professional services are performed for a period exceeding 183 days in the calendar year concerned. This addition of the criterion of "duration of stay" is in accordance with the UN Model, though not completely, because the UN Model mentions a certain amount of remuneration as a third criterion.

Pensions and annuities (Art. 18)

Contrary to the Model, pensions and annuities can be taxed by both the source and residence country provided that the source country's tax does not exceed 15% of the gross amount.

Elimination of double taxation (Art. 22)

Canada eliminates double taxation (unless a greater deduction or relief is granted under national law) by allowing a deduction of tax payable on profits, income or gains in the Ivory Coast. Tax payable in the Ivory Coast is deemed to include any amount which normally would have been payable but is exempted under the investment law.[8] This latter provision is of vital importance to developing countries because of the fact that without such a clause the benefits of their tax incentives for investment would not accrue to the foreign investor but to the treasury of the capital-exporting State. Without such a clause or comparable unilateral clauses, tax incentives in developing countries are nothing more than a transfer of capital from developing to developed countries, which of course is a ridiculous situation. Strangely enough, neither the Model nor the UN Model incorporates such a clause, but it has been discussed by the U.N. Group.[9] The Convention also provides for an elimination of economic double taxation by way of an affiliation privilege granted by Canada to resident companies receiving dividends out of the exempt surplus of a foreign affiliate resident in the Ivory Coast. The determination of exempt surplus has to take place in accordance with Canadian law.

The Ivory Coast eliminates double taxation through the "exemption with progression method" in accordance with which income taxed in Canada is not taxed in the Ivory Coast but is taken into account when determining the rate of tax to be imposed on the rest of the income.

Non-discrimination

The Convention contains no clause comparable to Art. 24 of the Model (non-discrimination).

Diplomats (Art. 25)

A special provision is included pursuant to which diplomats, consular officers and permanent representatives of either Contracting State are considered residents of the sending State if they are liable, in that State, to tax obligations, as are normal residents. This fills the gap which resulted from deletion of the sentence mentioned in the commentary on Art. 4 defining the word "resident".

Tax evasion (Art. 26)

The Convention includes the normal provisions on adjustment of non-arm's length transactions between associated enterprises (Arts. 7, 9, 11 and 12). Apart from this, the Convention provides that it shall not be construed so as to prevent application of national anti-evasion measures. Moreover, the Convention is not applicable to resident companies owned or controlled by non-residents, if the actual corporate income tax is substantially lower than the amount that would be imposed if the company were owned by residents.

Entry into force (Art. 27)

The Convention shall enter into force on the moment of exchange of instruments of ratification. It will apply, for Canada, on 1 January of the calendar year following entry into force as far as non-resident withholding taxes are concerned. In respect of all other taxes it will apply for taxation years starting on or after that date.

For the Ivory Coast it will also apply, as far as non-resident withholding taxes are concerned, on 1 January of the year following entry into force. In respect of other taxes it will apply for taxable periods ending on or after that date.

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8. Law 59-134 of 3 September 1959 concerning private investment or any other provisions subsequently made and agreed by the Contracting States to be of a substantially similar character.
9. UN Model, note 3, at 184.

EC and EFTA Liberalize Industrial Trade

Statement by Vice-President Wilhelm Haferkamp

1. On 1 January 1984 the European Community and its EFTA-partners will have abolished – with few small and temporary exceptions – all tariff barriers and quantitative restrictions in their mutual trade with industrial products. We will then have achieved the largest free trade area for industrial goods in the world. With their 312 million consumers the European Community and EFTA already now form a bigger market than the United States and Canada taken together. Spanish accession to the Community will add another 38 million. The EC-EFTA free trade area will then comprise the whole of Western Europe in a European free trade zone.

2. We must congratulate ourselves on reaching this milestone. In 1972, when we signed the Free Trade Agreements, voices on both sides expressed doubts on the wisdom of such a vast undertaking. And if we could have foreseen the depth of the recession, which began when the ink on the Agreements was scarcely dry, we might never have come this way. But wise counsels prevailed and we have been able to achieve our goal against all protectionist tendencies and in spite of serious difficulties in some sectors of our industry such as paper, steel and textiles. In doing so we have proved that it is possible to work towards trade liberalisation even in times of great economic difficulties. This brings out the full significance of our achievement.

3. Congratulations are also justified for the ever growing cooperation between the EC and EFTA beyond the trade aspects of the agreements. This has created a network of cooperation, consultation and contacts going further than with any other industrialised partner. It now covers many areas ranging from consumer protection to telecommunications, environment etc. A very positive development also is the multiplication of our contacts in the framework of international organisations like GATT and OECD, allowing for coordination of our positions whenever and wherever possible. Regular ministerial consultations have furthermore provided a valuable opportunity to extend our cooperation into the political field with those EFTA partners who so wished.

4. Encouraged by the success of the first decade of our cooperation, we should now look ahead to the second decade. Ideally, it should lead us to a situation in which our industrial producers should be able to consider the whole of Western Europe as their home market.

ANNEX

EC + EFTA = THE EUROPEAN FREE TRADE ZONE

FREE TRADE FOR INDUSTRIAL PRODUCTS[1]

The Free Trade Agreements were signed on 22 July 1972 by Austria, Iceland, Sweden and Switzerland, on 14 May 1973 by Norway and on 5 October 1973 by Finland. They came into force on 1 January 1973 except for Norway (1 July 1973) and Finland (1 January 1974). At that period agreements were also signed by the European Coal and Steel Community and each of the EFTA countries.

The dismantling of tariff barriers

From 1 January 1984 all tariffs will be abolished in trade between the Community and the individual EFTA countries. (Exceptions are Finland, where the last reduction will take place on 1 January 1985, and Iceland, where certain customs duties of a fiscal nature may be temporarily retained.)

This result was achieved following three different timetables:

1. For the great majority of tariff headings duties were eliminated progressively during the period between the agreement coming into force and 1 July 1977.

2. For a second group of products, mainly non-ferrous metals and textiles, the tariff reductions took place over a longer period up till 1 January 1980. During this period the parties set indicative ceilings for imports beyond which higher duties applicable to third countries in general could be reimposed.

3. For the most sensitive products, paper on the Community side and a variety of products for the individual EFTA countries, the timetable for dismantling tariffs was extended till 1 January 1984 with the same possibility of fixing indicative ceilings.

A small number of products have been totally excluded from the agreement. These are mainly agricultural products which are classified as industrial in the Customs Nomenclature (albumins, cork, flax and hemp).

The abolition of quantitative restrictions

Quantitative restrictions were abolished in bilateral trade at the date of entry into force of the agreements. Certain of the EFTA countries have retained a small number of quantitative restrictions, namely Finland (various oil products and fertilisers), Iceland (various oil products and brushes) and Austria (antibiotics).

Agriculture

Apart from the agreement with Iceland where tariff concessions were granted for certain fish products, no liberalisation

1. Although Portugal is a member of EFTA and therefore of the free trade zone, its trading relationship with the Community is different from that of the other EFTA states and will not be mentioned further in this note. It is recalled that Portugal is a candidate, with Spain, for accession to the Community.

of primary agricultural trade was provided for in the Free Trade Agreements. Since, however, the dismantling also covers the industrial element of processed agricultural products, a special Protocol was added to each agreement setting out a common interpretation as to how this would be done.

The parties declared their readiness in the Agreements to foster the harmonious development of trade in the agricultural sector. Specific bilateral agreements have since been negotiated with a number of EFTA countries, mainly in the cheese sector, to promote an orderly bilateral trade in cheese (Finland, Austria and Norway). An agreement has also been signed with Austria granting reciprocal recognition of "appellation d'origine" for wine.

To encourage the development of agricultural trade Austria, Switzerland, Norway and Sweden, on the one hand, and the Community on the other, decided shortly before the signing of the Free Trade Agreements to grant each other autonomous tariff concessions on certain primary agricultural products. These concessions, which varied in each case, covered a variety of products including fruit, wine and fish.

Rules of origin

Since the free trade zone is not a customs union it was necessary to establish rules to define clearly which goods could be eligible for duty free treatment. This was to stop goods entering the free trade area through the country with the lowest customs tariff.

In an effort to simplify these rules, which are of necessity complex, the EC and EFTA agreed on an alternative system for defining the origin for certain products in the engineering sector. A Commission proposal to encourage joint production by several EFTA countries through a liberalisation of the origin rules for export to the Community is still under study.

COOPERATION BEYOND THE FREE TRADE AGREEMENTS

All the Free Trade Agreements, except the one with Finland, have an evolutive clause allowing for cooperation outside the trade area. These provisions have been extensively used by all concerned and an interlinking network of cooperation activities has been set up.

A particularly useful area of cooperation has been the regular exchanges of information on a wide variety of subjects including:

- Economic and Monetary Policy
- Environment
- Workers' Health and Safety
- Consumer Protection
- Transports
- Development Aid
- Energy
- Industrial Policy.

In order to deal with difficulties in the steel market during the present recession, the Community on the one side and Austria, Norway, Finland and Sweden on the other, have negotiated annual steel arrangements to regulate bilateral trade in these products.

Sweden, Finland and Switzerland have also interconnected their data transmission networks with the Community's EURONET and with each other's networks. A similar arrangement with Austria has been submitted to the EC Council of Ministers. Norway has recently expressed an interest in establishing a link with EURONET as well.

In the field of science and technology, all the EFTA countries, with the exception of Iceland, participate in the Community's COST programme (Cooperation in Science and Technology).

Switzerland and Sweden also participate in the Community's nuclear fusion research project, the Joint European Torus in the United Kingdom.

Finally, in this area the Community and Switzerland do joint research into cellular ageing and congenital anomalies while research is in progress with Sweden into wood as a renewable raw material.

In June 1983, the Commission presented to the Council a list of possible areas where cooperation with the EFTA countries could be set in motion or developed.

This cooperation has greatly been strengthened by frequent exchanges of visits at ministerial level. A clear indication of the interest shown by both sides is that in the past two years the Prime Ministers of Sweden and Norway and the Swiss Federal Counsellor for the Public Economy have visited the Commission while Commission President Gaston E. Thorn has visited Finland and Switzerland.

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Unitary Approaches in International Taxation

By Friedhelm Jacob

PREFACE

The following paper contains some reflections on the issue of taxation by world-wide combination of group business income and formula apportionment.

In an introductory part it summarizes the reactions by international bodies to methods of international income allocation different from the arm's length principle. Part II deals with the international implications of formula apportionment by sub-national and national jurisdictions. The incidence of unitary state taxation in the United States and that of the German trade tax, as well as the treatment of both types of taxes in the U.S.-German tax treaty, are discussed in more detail. Part III examines possible implications for less developed countries inclined to adopt unitary systems as well as some of the difficulties inherent to the arm's length standard. Part IV points out more "modern" ways of dealing with the alleged disadvantages of separate-entity approaches, ways which do not depart from an arm's length concept while trying to avoid the shortcomings of formulary systems.

The views expressed in this paper, though those of a German tax administrator, do not necessarily coincide with those of the German Government.

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Contents

I. INTRODUCTION

Over the past decade concern has been voiced time and again by industrial circles investing in the United States with regard to excessive State taxation under so-called "unitary" methods. Criticism has been focused on a method of state taxation commonly referred to as "world-wide unitary combination with formula apportionment", with California being one of the more prominent users of this approach. According to this concept, the taxable income of a business entity located in a "unitary" state is determined first by ascertaining the overall (net) income of the unitary business enterprise of which the taxable entity is considered to be a part. This unitary business enterprise can be made up of one legal entity with various outlets (permanent establishments) or of a group of interrelated or associated corporations. Unitary world-wide combination includes both domestic and foreign parts or members of a unitary business and adds up the combined income of the entire corporate group after intra-group (or intra-business) transactions have been eliminated. As a second step, a portion of the net group income is attributed to the unitary state entity; for this purpose, normally, the ratios which the in-state figures for (third party) sales, payroll, and assets bear to the same factors of the entire group are each applied to one third of combined group income.

Large multinational enterprises (MNEs) as well as business associations have either gone on record themselves deploring that unitary taxation amounts to a deviation from internationally accepted standards or have successfully solicited the support of their home governments and international tax law bodies in formulating outspoken positions against world-wide combination and formula apportionment of income. While any resulting multiple tax burden must have been a cost factor in the MNEs' books all along, the opposition to such practices, at least in the Western European tax community, seems to have reached a new dimension only in the past few years.

One can but speculate whether this is due to a more aggressive attitude on the part of the states in implementing their laws and/or an increasing weight of any additional cost item in corporate profitability during a recession. Surely, the growing international awareness of transfer pricing issues, together with early signs of economic recovery in the United States, has put the removal of obstacles to a favorable tax environment for renewed investment into the top priorities for corporate lobbying; from a German viewpoint, the still pending renegotiation of the German-U.S. tax treaty may appear to those interested to be the right forum to press for solutions on a bilateral level. Moreover, the recent U.S. Supreme Court decisions in the *Container, Shell* and *Alcan* cases can be viewed as granting ample scope for maneuvering to those states wishing to maintain or introduce unitary taxation. Although the Court had indicated in the *Container* case that the treatment of subsidiaries of foreign corporations might well follow different (i.e. more restrictive) rules, the more recent rulings have by all means increased the concern on the part of non-U.S. business circles investing in the United States.

Tax officials representing their administrations in the OECD Committee on Fiscal Affairs expressed their views on "global" profit allocation in the 1979 Report on Transfer Pricing and Multinational Enterprises. Considering the many qualifications, provisos, and caveats which characterize the statements otherwise contained in this report, the stand taken on the issue of global methods is amazingly outspoken and unambiguous in that it clearly rejects the idea of income computation based on formula apportionment as a viable alternative to separate entity approaches on an arm's length basis.[1] As opposed to unitary combination of income, the arm's length principle calls for a separate entity approach to allocating the taxable income of internationally related enterprises. Under this standard, the "transfer" prices used by the enterprises in their intra-group or intra-business billings are accepted for tax purposes if they correspond to what unrelated parties to a comparable transaction would have agreed upon under comparable circumstances.

Of course, due to the scope of the OECD Report,[2] its statements apply primarily to the taxation of separately incorporated, associated enterprises. It should therefore be interpreted as a view which emphasizes the need to respect corporate structures and to refrain from piercing the corporate veil. Apparently the Report does not intend to supersede the views expressed by the OECD on the question of apportionment (or "indirect") methods of income allocation between the various parts of one enterprise acting through foreign permanent establishments.[3] Hence, there is some room for unitary approaches, which, however, are considered an admissible proxy for arm's length standards only if its results approximate "as closely as possible to the figures that would have been produced on a separate accounts basis",[4] and if it has "as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory".[5]

It is noteworthy that the UN Group of Experts, irrespective of the differences in opinion on other issues of permanent establishment taxation, in their Model Treaty Between Developed and Developing Countries fully subscribed to the views expressed by the OECD on unitary methods. This deserves special attention as the UN Model, though representing a compromise between residence and source taxation rights, gives more weight to the source principle than the OECD Model does.[6]

With this high degree of consensus reached internationally on the demerits of unitary principles, one might be inclined to simply sit back, accept multiple tax burdens as a fact of life,[7] and watch for an outcome of the ongoing discussions in the United States, one in which the U.S. administration is caught in the crossfire between state politicians seeking to safeguard their urgently needed state revenues and multinationals either overtly opposing unitary taxation, flexing their muscles in a "just-you-wait" spirit, or hinting at ways to circumvent formula apportionment. However, there is more than one reason for not just assuming a spectator's role vis-à-vis a supposedly "internal" U.S. tax issue, for (a) the use of unitary approaches is not confined to authorities below the national level; (b) the arm's length principle is by no means the panacea for all tax problems inherent to transactions across national borders; (c) formula apportionment may be attractive to LDCs because it eliminates the problem of inter-company pricing; and (d) more "modern" techniques in the application of the arm's length standard may be available as a compromise between both approaches and as a basis for closer cooperation between the tax authorities of both developed and less developed countries.

II. INTERNATIONAL IMPLICATIONS OF NON-ARM'S LENGTH APPROACHES

1. Non-arm's length approaches in sub-national taxation

When examining the justification for state (income) taxation the two well-known concepts of residence and source taxation come to mind as an acceptable link between the taxpayer's activities and the entitlement to a government take.[8]

a. Unitary state taxing permanent establishment of German enterprise

In the case of a German-based corporation with a U.S. permanent establishment (p.e.), absent the nexus of "tax home",[9] the state's entitlement to revenue would appear to be limited to taxation based on the source principle.

1. See Para. 14 of the Report.
2. See Para. 7, footnote 1, of the Report.
3. See OECD Model 1977, Commentary on Article 7, Paras. 24, et seq.
4. Id., Para. 26.
5. Id., Para. 24.
6. United Nations (1980), p. 5.
7. Tax treaties entered into by the United States do not apply to State taxes. Absent unilateral relief granted by the investor's home country, state taxes are not creditable nor are there limits on (U.S.) state taxes for the inclusion of foreign-source income.
8. Plasschaert (1981), p. 409.
9. The place of commercial domicile and/or statutory seat.

Unitary states indeed claim that they are exercising their taxation powers within the limits of this principle. It is worth noting that the source principle, while excluding the taxation of world-wide income, does not per se require all income items stemming from abroad to be left untaxed domestically. If there is reasonable connection between the taxing jurisdiction and the activities performed or assets used by the taxable entity in generating the respective income, nothing, in theory, would appear to prevent the state from taxing inflows of income to its jurisdiction irrespective of where the payer is located. Non-resident taxation under German income tax law is based on this principle. The law[10] enumerates those items of income for which a sufficiently strong connection, in an economic sense, is considered to be present and to justify taxation. The enumeration, on the one hand, does not include all items of income geographically allocable to German territory and tacitly includes foreign-source income, on the other. It is for major foreign-source income items that the lawmakers recently felt the necessity to grant unilateral relief in the form of a foreign tax credit.[11] Double taxation, in this situation, cannot be avoided under tax treaties since a p.e. is not normally eligible for treaty protection. The "source" principle, applied according to this interpretation, is not fully equivalent with "territoriality" although there are overlapping areas.

The practice of some states which include in gross apportionable income dividends received by foreign entities shows that combination of world-wide income of the unitary business and apportionment of some part of it to the p.e. located in the unitary state goes well beyond the (limiting) criterion of "sufficiently strong economic connection". Unitary taxation operates on the basis of various assumptions. One of them is that in a unitary business all operations are conducted to benefit the overall business and that the various parts of that unitary business are dependent upon and contributory to each other. Adequate nexus for the power to tax is therefore established by the mere fact that intra-state activities form part of the unitary business at stake. This basic assumption shows that the unitary rule works on a footing diametrically opposite to arm's length standards. It is fair to say that unitary taxation is not intended to produce figures approximating as closely as possible to arm's length results and therefore does not qualify as an adequate proxy for this method within the meaning of Art. 7(4), OECD Model 1977. Under unitary methods, the separability of items of income follows neither corporate nor political boundary lines; the only source of business income is the unitary business itself no matter where, geographically, contributions to this income were made. A concept of full interchangeability and inseparability of activities and complete fungibility of funds necessarily discards both residence and source considerations in computing apportionable combined income and only seemingly fulfills the task it allegedly pursues, that of delineating that portion of combined income which can reasonably be traced back and allocated to the state. If performance by the taxable entity represents a contribution which is inextricably dependent on other entities' performance and the value of which is therefore impossible to assess separately, and if world-wide dispersion of activities by corporate management is viewed as haphazard or based on decisions in part guided by the aim of tax minimization,[12] it does not appear to be very consistent to link up the tax treatment of the state-based entity to the very same corporate decisions (i.e. those determining the volume of assets and sales and the personnel employed in a given enterprise) in order to ascertain the value of the performance originating in this state's territory.

Unitary apportionment requires further assumptions in computing the allocable portion on the basis of capital, sales, and payroll; the one here is that all of these factors contribute *evenly* to the overall success (or failure) of the unitary business no matter in which economic environment they are put to use, in what competitive situation, etc.[13] Criteria such as location savings, start-up losses, or mismanagement cannot be accounted for.[14] Sharp geographical differences in profitability are leveled out by the application of the three-factor formula. This process of income allocation siphons away, as it were, profits from other parts of the business to loss-making entities, which, in generating the loss, have themselves operated with assets, have paid salaries, and have recorded third-party business receipts and thus qualify for an allocation of parts of the overall positive results. Special competitive situations show best of all how unitary taxation crosses the dividing line between source and residence taxation and enters extra-jurisdictional territory. With the criteria for delineating a unitary business lacking the possibility of "fine tuning" (e.g. by allowing for the entity operating under such special circumstances to remain outside the scope of the unitary business), the state applying those criteria clearly treads on other jurisdictions' grounds by subjecting their profitable (e.g. conservatively investing) entities' income to taxation in a geographical area where loss-making undertakings are carried out (e.g. due to excessive risks assumed, pricing regulations, etc.). This distortion is only partially offset by the fact that the loss itself reduces the business income before apportionment.[15]

No relief for double taxation resulting from unitary state taxation of a U.S. p.e. of a German enterprise is granted under the German-U.S. tax treaty. German unilateral relief measures are generally inapplicable as the p.e.'s income is normally exempted from German tax. There is, however, the option between claiming a foreign tax credit for, and the deduction of, state taxes from the taxable income of the domestic enterprise (Para. 34c(6), 3rd sentence, Income Tax Law) where the state taxes U.S. branches of German shipping and air transport enterprises (for which Germany has not given up taxing rights under the treaty).

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10. See Para. 49, Income Tax Law.
11. See Para. 50(6) in conjunction with Para. 34c(1)-(3), Income Tax Law.
12. Church and Pomp (1980), pp. 891 (897).
13. Palmieri-Egger (1983), pp. 59 (60).
14. According to reports on the Unitary Task Force's hearings in November 1983, state representatives have begun to realize that flexibility in the apportionment is needed to take proper account of special circumstances of the individual taxpayer; see Sheppard (1983), p. 822.
15. It is conceivable that unitary apportionment might also lead to results to the advantage of the taxpayer, e.g. where a highly profitable entity benefits from the offsetting effects of out-of-state entities' losses. The result will be double exemption of income. See Redmond (1981), p. 99 and infra, II.3.

b. Unitary state taxing subsidiary of German parent

The nexus between a separately incorporated enterprise and state taxation rights appears to be stronger than in the case of a p.e. But even if separate incorporation, albeit under full or substantial control from abroad, were to establish the nexus considered necessary to exercise taxation rights under the residence principle, the same would only justify taxing world-wide income earned by the taxable entity itself (including dividends received from "second-generation" affiliates); it would, however, not appear to give any grounds for combining a U.S.-based controlled corporation's income with that generated by "upstream" non-U.S. affiliates (e.g. that of a parent or sister corporation) as this would result in the taxation of income earned by entities which themselves have no ties with the unitary state sufficient to subject them to that state's tax jurisdiction. An approach which would follow the unitary method's substance-versus-form argument (and disregard the corporate structure) would, in an economic sense, result in the treatment of a foreign-controlled entity as a permanent establishment of the controlling shareholder,[16] a position clearly rejected in Art. 5(7) OECD Model 1977 and Art. 5(8) UN Model.[17]

For the German parent, relief by Germany is not available with respect to federal or state taxes on a U.S. subsidiary's current business income. As regards dividends, the U.S.-German tax treaty provides for an exemption of foreign-source dividends if at least 25% (10% in taxable year 1984) of the shares are held by the parent. Any U.S. withholding tax on dividends and any tax levied on "underlying" income, out of which the distribution was made, becomes definitive. Hence, any final economic burden reflected in unitary taxation will not be offset by a corresponding reduction of German taxes even though unitary tax may result in taxing portions of income currently earned by non-U.S. entities.[18] The result is international double taxation.

c. Unitary state taxing state-based enterprise with German permanent establishment

From a German viewpoint, little in theory could be held against a state using the residence principle if the taxable entity, e.g. a corporation, has chosen this state as its "tax home". Under the German system of fiscal federalism, sub-national jurisdictions share in the tax revenue collected under federal rules.[19] If these rules are based on the residence principle, there remain only technical differences between the state entitlement to tax under a shared-revenues concept and a separate state income tax (over and above a federal tax) on world-wide income.

If the unitary state includes in its tax base foreign-source income generated through the activities of a non-U.S. p.e., the typical clash between residence and source taxation occurs. Presuming the source country (host country of the permanent establishment) has computed the p.e.'s income equitably, it is up to the home country or state to relieve double taxation by granting a credit or exempting the foreign income. Where neither a tax treaty nor provisions in the statutes induce such relief, the (lobbyists') pressure will normally be on the home jurisdiction(s) to either "do something" or see the corporation move elsewhere.

d. Unitary state taxing state-based corporation with German subsidiary

The situation changes only marginally if the state taxation of a U.S.-based group of corporations is not only extended to non-U.S. p.e.s but also to separately incorporated foreign entities as part of a unitary business. Here unitary taxation with respect to the German entity can result in the immediate inclusion of part of its undistributed income in the tax base apportioned to the U.S.-based business in excess of what would appear appropriate under arm's length standards.[20] Simultaneously, income earned by the German entity is taxed there under arm's length rules. In some states[21] this is compounded by the taxation of distributed income in the hands of the state-based parent; in addition, tax is withheld at source in Germany from the dividends paid to the U.S. parent.

In this situation the clash of tax claims occurs between subsidiary country residence and parent corporation residence (state) taxation for the undistributed subsidiary income (which may include fully taxed portfolio dividends received by the German subsidiary!), and source and residence taxation with respect to the dividends. The first situation is commonly labeled "economic double taxation" as opposed to "juridical" double taxation in the second case. Again, relief for the resulting multiple tax burden is the task of the group's home jurisdiction(s). Claims against the non-U.S. entity's host country are unjustified because, as seen from this country's viewpoint, there is no foreign-source income which underlies taxes levied by the unitary state. Moreover, the non-U.S. entity is not the one which is left at a competitive disadvantage as the (state's) tax claim, though based on (part of) the non-U.S. entity's income, economically burdens the U.S. parent.

One may conclude that in the case of a U.S.-based corporation or group of corporations, unitary taxation by a U.S. state cannot reasonably give grounds for a sacrifice of revenue or waiver of taxing rights on the part of the non-U.S. jurisdictions. It is up to the corporation's or group's home jurisdiction to tailor its tax system to find an adequate balance between revenue needs and a tax

16. Along with an income computation under the "indirect method" within the meaning of Art. 7(4) OECD Model 1977.

17. German High Tax Court jurisprudence has favored such an approach – called *Filialtheorie* – since 1930 when it was first applied in the famous decision on the Shell case. The German-Italian tax treaty of 1925 is the only one left which does not contain the equivalent of Art. 5(7) OECD Model 1977, a provision which has been included into other German treaties ever since 1931. See Müller (1970), pp. 145, 156.

18. Kaplan considers the issue of "true tax burdens not offset by reduced taxes elsewhere" one of the real questions involved. See Kaplan (1983), p. 203; and the example on page 24 and Chart III.

19. The *Länder* are entitled to 50% of the revenue from corporate income tax. Their aggregate share is apportioned to the individual *Land* according to the same criteria used in apportioning the taxable base of the Trade Tax to eligible municipalities (see infra, II.2.e). The *Länder*'s share in revenue from personal income tax amounts to 43%; the allocation to the individual *Land* follows the residence principle. For details, see the *Zerlegungsgesetz* of 29 March 1952, last amended in 1970 *(Federal Law Gazette* 1970, Part I, p. 1727).

20. In a parent-subsidiary context this has the same effect as the elimination of deferral. See Church and Pomp (1980), p. 894.

21. Some states exempt intra-group distributed income from apportionable group business income and tax dividends – without relief for foreign withholding or other taxes – as non-business income upon distribution, provided the recipient's commercial domicile is in that state. Other states apportion dividends along with all other income. See Redmond (1981), p. 101.

environment prone to attract business. This is not to say, however, that the non-U.S. entity's host government need not be concerned about the whole situation. A possible strategy on the part of the U.S.-based business might be to detour profits away from the non-U.S. entity, instead of trying to minimize taxes in its home country or state, in order to alleviate the multiple tax burden. Thus, unitary taxation, though designed in an effort to counter tax avoidance, may well be enough reason in itself for income shifting into tax havens.

e. Formula apportionment for German trade tax; treaty implications

The somewhat unsatisfactory result just outlined – tantamount to partially unrelieved double taxation where foreign-source income is subject to unitary taxation without allowances made for the equitable exercise of foreign taxing rights – is primarily due to the unitary states' tax statutes. These statutes are not superseded by U.S. tax treaties as these are not applicable to U.S. state income taxes. The U.S.-German treaty, however, does cover the German trade tax (Gewerbesteuer), the revenues of which accrue predominantly to jurisdictions below the federal level, i.e. states (*Länder*) and municipalities. One may therefore ask if there is not a built-in equity in the treaty itself insofar as U.S.-based enterprises enjoy (partial) relief from trade tax whereas unitary state taxes cannot be credited against German trade or corporate taxes in the case of German taxpayers. These questions are so much the more justified as the Trade Tax Law also works with formula apportionment.

A factor in any identifiable imbalance under the present treaty would be the systemic differences between German trade tax and unitary state tax. Although there is a very involved system of revenue sharing and transfer payments between the federal, state, and local levels of government in Germany for various types of taxes and levies, the trade tax still constitutes an important source of revenue for the municipalities. The justification for its existence is seen in the direct and indirect economic burdens on municipalities caused by business enterprises (construction of roads, parking space, development of industrial zones, public transportation, fire departments, etc.).

The tax has a dual base, i.e. business profits and capital invested in the business. The starting point for the determination of the profit component is the net business income determined under the Income or Corporation Tax Law (and hence under the arm's length principle, if income allocation between domestic and foreign affiliates is at stake); certain additions to, and deductions from, this figure are to account for the fact that this tax is based on the earning power of the business as such, irrespective of the earning power of its owners or the personal circumstances of the entrepreneur. One major item to be added to net business income is 60% (taxable year 1983) or 50% (taxable year 1984) of the interest on long-term loan capital, insofar as the interest was treated as a deduction in arriving at net business income. This addition is supposed to put businesses working with borrowed funds on an equal footing with those with ample equity capital.

The capital component for the tax base is determined on the basis of assessed values for the business entity (normally much lower than the fair market or going concern values). Certain additions and deductions are made. Again, an important addition is that for 60 or 50% of the long-term loan capital, insofar as it was treated as a deductible item in arriving at the assessed value.

The overall tax base is computed for each legal entity located in Germany. German p.e.s of foreign corporations are treated as if they were separately incorporated (domestic) enterprises. Corporate structures are, in principle, respected. Separate legal entities are lumped together only where fiscal unity[22] exists. Moreover, there are instances where tax planning measures designed to avoid trade tax by business split-ups are not recognized under substance-versus-form rules and the split-up is treated as one integrated business.

The overall tax base for the business entity is apportioned to the individual municipalities in which the p.e.s[23] of the business are located.[24] For all industries, the p.e.'s payroll over total payroll is used except for retailers in merchandise where half of the taxable portion is arrived at using the payroll ratio and the other half by using a business receipts ratio.[25] As the trade tax is based on federal law, the apportionment formula is uniform for the whole country. As opposed to the rather mixed tax environment in the United States, created by the individual state income tax laws which differ in spite of the model recommended in the Uniform Division of the Income for Tax Purposes Act (UDITPA), the aggregate of apportioned tax bases cannot exceed 100% of the apportionable tax base for one enterprise, or one group of enterprises joined by fiscal unity, under the Trade Tax Law. The municipalities apply their individual percentage rate (Hebesatz) to the apportioned tax base. A municipality is free to legislate on this rate within certain limits set by state law[26] and the constraints of finding an adequate balance between revenue needs and attracting business.

While some of these features bear a certain resemblance to some U.S. state tax law systems, the important difference is that the German Trade Tax Law provides for the exclusion from the taxable base of major foreign-source items, such as income attributable to a foreign p.e., or dividends received from foreign corporations engaged in active trade or business, provided the domestic enterprise holds at least 25% (taxable year 1983) or 10% (taxable year 1984) of the shares of the foreign entity. Hence, as international double taxation with respect to German enterprises is presently to a large extent avoided due to the mechanism of the Trade Tax Law, no apparent need was felt to provide in the tax treaty itself for a credit

22. *Organschaft;* there is fiscal unity where a corporation is integrated into another business enterprise. Integration comes about through (a) ownership of the majority of the voting rights, (b) economic, and (c) organizational interdependence. Fiscal unity cannot be construed to exist with foreign enterprises, although integration into a domestic p.e. of a foreign enterprise is possible if certain requirements are met.
23. In the case of fiscal unity, entities integrated into the controlling business are treated as p.e.s for the purpose of apportionment.
24. Similar apportionment is necessary where one p.e. is located in more than one municipality.
25. See Para. 29(1), Trade Tax Law.
26. See Para. 16, Trade Tax Law.

against trade tax for the remainder of cases in which foreign taxes are levied on foreign income not already exempted from trade tax. Moreover, where income is not so exempted, a credit for foreign taxes similar in character to German income or corporate income tax is granted against German income or corporation taxes. If taxes, e.g. on foreign non-business income received by a German entity, are absorbed in this way, there would be no apparent need to credit such taxes a second time. Under special circumstances, of course, a loss-making entity might not be able to make use of such foreign tax credit against its income or corporation tax and still have a trade tax liability. The reason for this can be the addition to be made to federal net income in computing the trade tax base. An example might be a domestic corporation with substantial foreign portfolio dividends (participation exemption not applicable), which expands its domestic activities, finances this expansion by heavy borrowing and in addition incurs market penetration losses. If the dividend income is slightly greater than, or equal to, the penetration losses, this company would show a loss for corporation tax purposes and would carry a trade tax burden of roughly 15% of the loan interest. In this case a credit against trade tax for foreign withholding tax on the portfolio dividends might appear warranted in order to eliminate international double taxation, which, in the absence of foreign tax credit carry-over rules under German law, will otherwise not even be avoided in later years when the corporation, for corporation tax purposes, might show profits again. One reason why no provision was made in the treaty for a credit against trade tax might be that major cuts in trade tax revenue would primarily and most heavily affect the budgetary situation of municipalities which are entitled to 60% of aggregate trade tax collected. It might be feared that the carefully designed system of revenue sharing would be all too easily upset by direct impacts on an important revenue source of the municipalities, with trade tax reacting procyclically anyway. The difficulties in administering such a tax credit as a stand-by relief measure (i.e. contingent on unrelieved double taxation on the income tax level) may be another reason for not granting it at all.

In the bilateral U.S.-German context, all of the above considerations, however, take as a starting point the assumption that state taxes as well as the trade tax have to be viewed in the context of revenue sharing with the federal level and that they are designed in an effort to create inter-*state* equity. The economic and fiscal balance underlying these considerations is upset where sub-national taxation departs from these premises and takes on an international dimension and incidence, thus entering the realm of inter-*country* equity.

Under the Trade Tax Law, there is a combination of domestic entities' income under circumstances which the taxpayer can influence to a high degree by providing for the contractual or organizational framework in order to enjoy intra-group profits and loss consolidation (group relief). On the other hand, there is no combination of domestic entities' income with that of foreign affiliates. Hence, the trade tax can be viewed as a surtax at regionally varying rates, levied in addition to, and computed by a certain degree of piggy-backing on the tax base of, income/corporation taxes as well as the net wealth tax. It avoids almost entirely any international incidence normally associated with unitary state taxes, as combination ends at "borders' edge"[27] and the delineation of the apportionable tax base[28] is executed under arm's length standards. This is the reason why the U.S. Federal Government, along the lines of its treaty policy based on the foreign tax credit system, grants a tax credit for that portion of the trade tax which is computed on the basis of profits (Art. XV(1)(a) of the U.S.-German tax treaty). As opposed to this tax environment for U.S. companies, German enterprises enjoy the benefits of the exemption method with respect to a foreign p.e.'s income and dividends from substantial participations. Where the foreign tax claim is based on income in excess of what can be exempted under internationally recognized attribution rules in Germany, the resulting double tax burden runs counter to the spirit of the treaty.[29]

By the same token, it is worth taking a second look at a possible international incidence of the trade tax. One conceptual weakness of this tax might be seen in the formula apportionment of taxable amounts to the various municipalities. If apportionment is to result in an equitable remuneration for bearing the burden of providing infrastructure, one- or two-factor formulas applied to possibly highly diversified (domestic) corporations and partnerships[30] operating through (domestic) branches are no guarantee for an adequate yardstick. On the other hand, one may view this as an "internal" problem because serious distortions are not likely to arise due to the formula apportionment being limited to domestic companies. In spite of differential municipal tax levels, domestic businesses operate in a fairly homogeneous environment, one in which differences in payroll and investment costs as well as risk factors are not nearly as significant as in an international context.[31]

Nevertheless, the apportionment, e.g. by means of the payroll ratio, may have an international incidence in the context of the indirect tax credit.[32] A U.S.-based parent with a German subsidiary corporation (which, in turn, acts through a branch) is eligible for the indirect tax credit upon receipt of dividends from the German subsidiary, and trade tax is likely to be part of the underlying tax, i.e. the tax levied on the subsidiary's earnings and profits out of which the dividend was paid. If the trade tax rate applied by the municipality hosting the subsidiary's branch is significantly lower than that levied at the subsidiary's head office, and if the branch's personnel (smaller in size than that of the subsidiary's head office) is engaged in activities considerably more profitable than those of the subsidiary's head office, then the combination of subsidiary and branch income and sub-

27. For a discussion of a "water's edge" concept, which would use apportionment factors to attribute income to various states within the United States but would consider any relationship with foreign entities under the arm's length standard, see Carlson and Galper (forthcoming).

28. So-called *einheitlicher Steuermessbetrag*.

29. See Appendix I for the official German position on unitary state taxation submitted to the U.S. Treasury and State Department in November 1983.

30. Even high diversification of business activities undertaken by corporations or partnerships does not result in the tax treatment of these entities as more than one taxable business enterprise, whereas rules comparable to those which determine a "unitary business" apply in ascertaining the scope of each taxable business entity in the case of a sole proprietorship.

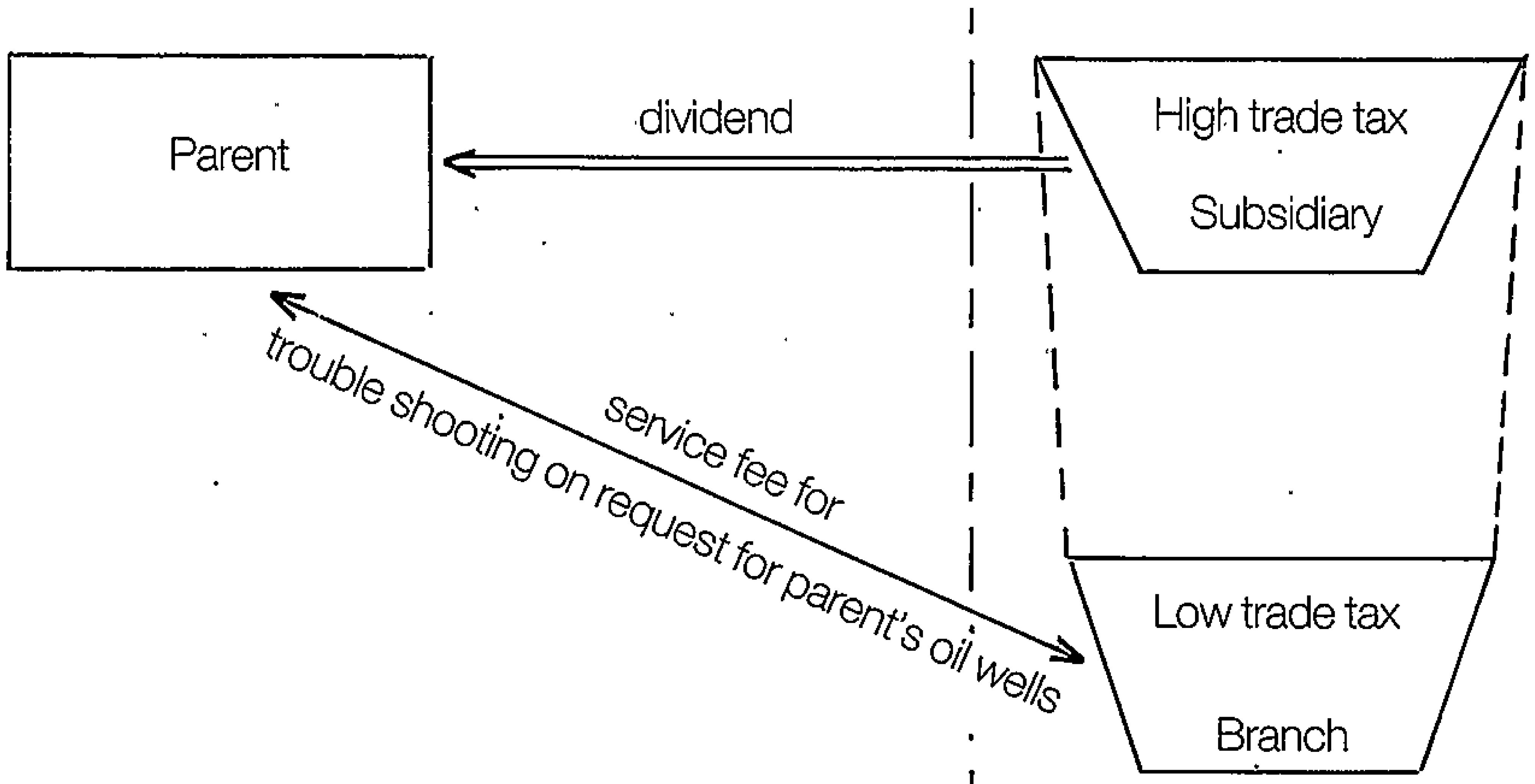
31. See Palmieri-Egger (1983), p. 393.

32. See Chart I for an illustration of the following example.

sequent application of the payroll ratio will result in an excessive allocation of income to the high-tax head office municipality. In view of the actual functions performed by the subsidiary, on the one hand, and its branch, on the other, it might, from a U.S. point of view, appear inequitable to grant the indirect tax credit for the full amount of trade tax (on profits) levied in Germany. However, the tax treatment of the German enterprise, in particular the *domestic* income allocation between headquarters and branch, would not appear to come under the articles of the tax treaty dealing with the *international* income allocation between headquarters and branch, or between affiliates. Competent authority consideration would therefore be unlikely. Remedies are, however, available under Paragraph 33 of the Trade Tax Law which permits the departure from formula apportionment to reach economically sound results and even provides for a tax computation on the basis of the taxpayer's proposals, provided all municipalities involved in the taxpayer's business agree.

CHART I

UNITED STATES



Note: Only the profit component of the trade tax is considered because IRS only credits this portion of the trade tax.

GERMANY

Functions	*Profits generated* (trade tax)	*Payroll*	*Apport. profit* (trade tax)
Holdings Europe	100	30	750
– administrative	(20)		(150)
– clerical personnel			
– low profit			
Trouble shooting	900	10	250
– highly risky	(90)		(25)
– highly trained pers.			
– very profitable			
Totals	1,000	40	1,000

If "high trade tax" amounts to approx. 20% of profits and "low trade tax" to approx. 10%, the total tax burden under payroll-ratio apportionment is 175 (20% of 750 + 10% of 250) as opposed to 110 (20% of 100 + 10% of 900) under arm's length allocation.

2. Non-arm's length approaches in national taxation

The issue of unitary approaches applied on a national level (as opposed to state or municipal levels) appears to be somewhat less burdened than that of state taxation reaching across international boundaries. Special complications such as that of a state's entitlement to legislate taxes with an international impact in spite of a federal government's monopoly to regulate foreign commerce do not arise. The same is true for the economic problem of differential tax levels within one nation prone to create misallocation of resources domestically.

Moreover, any double taxation arising, e.g. from the unharmonized application of rules on international income allocation, would, as a rule, be open to competent authority consideration under a tax treaty[33] whereas this is not the case if the treaty does not apply to the (State) tax.[34] Conversely, the fact finding necessary to determine double exemptions (created either by avoidance schemes or unharmonized allocation rules) could be executed on the basis of treaty clauses governing the exchange of information whereas information so exchanged may not be available for the implementation of taxes not covered by the treaty.[35] While these "remedial" procedures are more readily available for national than sub-national taxes under a treaty, it would appear desirable in the light of the clear preferences expressed internationally for national jurisdictions not to legislate unitary rules to begin with or, at least, not to implement them vis-à-vis a treaty partner where the treaty contains an equivalent of Art. 9 (or in the case of p.e.s, Art. 7) of the OECD Model. In this context it may appear useful to review a sample of national provisions bearing unitary traits.

a. "Some appropriate method of pricing"

In the discussion between state and federal governments in the United States, the proponents of unitary tax have made the point that the states are merely following the federal government's example of allocating income internationally. Adjustments under Sec. 482 IRC, it is argued, rely heavily on the so-called "fourth method" within the meaning of Reg. Para. 1.482-2(e)(1)(iii), and such method is supposed to be predicated on the principles of unitary taxation.[36] This statement must, of course, be evaluated in its domestic context and would appear to contribute little to validating unitary practices internationally even if it were correct. An examination of the audit procedures under Sec. 482 IRC conducted by

33. Some countries feel that such cases do not come under the mutual agreement procedure; see OECD (1983), Para. 76.
34. This does not exclude "voluntary" consideration in analogous application of Competent Authority Procedure rules; see Para. 1.2.4. of the German Administrative Transfer Pricing Regulations (Federal Ministry of Finance Circular of 23 February 1983, *Federal Tax Gazette*, Part I, (1983), p. 218; for an English and French translation, see Rädler and Jacob (forthcoming).
35. See Art. 26(1), OECD Model 1977.
36. See Church and Pomp (1980), pp. 891 et seq. (in particular, p. 896).

the U.S. General Accounting Office[37] gives little support to the argument that the majority of federal tax examinations and adjustments follow unitary schemes. What it does illustrate is that only a few adjustments were based on comparable uncontrolled prices, that a large percentage took recourse to safe haven rules, and that in many (i.e., the more complex) cases revenue agents had to use "some other" reasonable method. The examples given to illustrate such alternative methods show that combinations of the three "standard" methods[38] were applied and that analyses of the functions performed by the various group members involved in a transaction were often necessary to arrive at a reasonable third-party profit margin. This figure then was used as a mark-up on cost or as a deduction from gross receipts, depending on the particular circumstances. Nothing in the report indicates that combination of income, supplemented by factor apportionment, was used on the federal level. On the contrary: the absence of such practices constituted one of the reasons why the GAO recommended that a study be undertaken to determine whether formula apportionment is a viable alternative to the all too burdensome arm's length standard.[39]

b. Special U.S. rules for foreign banks

There are, however, fairly new regulations (Reg. Para. 1.882-5) on the deductibility of interest expenses incurred by U.S. branches of foreign corporations including multinational banks. The predecessor of these new rules, Reg. Para. 1.861-8,[40] contained the concept of full fungibility of money world-wide. While the computation of interest receipts of a U.S. branch followed the arm's length principle, i.e. was based on the effectively connected test of whether, and to what extent, the branch contributed to the acquisition of an income-producing asset, the deductibility of interest expenses was based on the idea that it is inappropriate to attempt to "earmark" those funds which were used in financing the lending activities of the branch, to trace them back to individual transactions (including those with the bank's head office or other foreign branches), and to identify market interest rates for each of them. The new regulations extend this concept in what is known as the "separate currency pools method" by modifying it into a theory of "fungibility of money within currencies". The same regulations, however, offer a second method, the "branch book/dollar pool method". Under this method, only the branch's own borrowing from third parties qualifies as interest expenditure at market rates and is used to calculate an average borrowing rate. For any additional intra-bank borrowing a mixed interest rate, representing the average interest rate for all third-party dollar borrowing by the bank, is used, irrespective of the various markets (and interest rates) in which these funds were raised. To arrive at the deductible amount of interest, the interest rates so computed are applied to what is considered the branch's liabilities effectively connected with its U.S. business activities. For this purpose, an appropriate amount deemed to represent interest-free equity capital allocable to the branch is deducted from the branch's assets. Absent a specific computation by the taxpayer of a world-wide liability-to-asset ratio, a safe haven rate of 5% of assets is used to allocate equity capital to the branch.

Long before much experience with the new rules and their practical results could be drawn upon, the rationale behind the concept of fungibility had met with severe criticism. One major concern is that a combination of the arm's length standard for the attribution of receipts with a formula approach for the apportionment of expenses, in the view of many observers, will increase the danger of automatic double taxation of certain income elements, or their double exemption, depending on the circumstances of the individual case, if the country in charge of the income allocation for the bank's head office follows the arm's length principle in toto.

The criticism against an allocation of equity capital to the branch is primarily based on the inherent administrative burden of worldwide (re-)computation of ratios (under U.S. accounting standards) and on the fact that the branch's equity capital is an amount imputed for tax purposes only and not one which the bank, as is the case under other countries' banking regulations, is required to actually show in its books so that the bank's customers are protected against unsafe business volumes. In addition, the regulations are criticized for being in contradiction with Para. 17 of the Commentary on Art. 7(3) of the OECD Model insofar as the regulations do not take into account payments made between the various parts of a banking business.

The efforts by competent authorities to overcome any resulting overlap of, or substantial gaps between, tax claims on the basis of the arm's length rule contained in the equivalent of Art. 7 of the OECD Model are somewhat overshadowed by the position taken in an earlier Revenue Ruling.[41] According to this ruling, the predecessor of Reg. Para. 1.882-5 was considered not to be superseded by the attribution rule for business income contained in the U.S.-Japanese tax treaty.

c. Other alternative methods under German law

(1) Estimates

In the absence of more meaningful data, the income attributable to a domestic entity can be estimated under Para. 1(3) of the German International Tax Law *(Aussensteuergesetz)*. This provision permits the income allocation to be based on a "normal return on the capital invested in the company", or on the profit on turnover, which can be expected and is customary under the circumstances present. The possibility of profit splits is not specifically addressed in this provision.

(2) Profit comparison – apportionment

Under Paras. 2.4.5. and 2.4.6. of the German Administrative Transfer Pricing Regulations,[42] a number of alternative methods is available to serve different purposes.

(a) As a first step the Regulations say that back-up material for the purpose of verifying ("double-checking") transfer prices established (and possibly examined)

37. See The Comptroller General (1981), pp. 30 et seq. and Appendices III, IV, and VII.
38. Comparable uncontrolled price method, resale price method, cost plus method.
39. See The Comptroller General (1981), pp. 50-54.
40. For a discussion of the old Regs., see Kaplan (1979), p. 3.
41. Revenue Ruling 78-4236 (1978-2C.B.194); see Kaplan (1979), p. 3.
42. *Federal Tax Gazette,* Part I (1983), p. 218.

under the "standard" methods can be gathered from an "internal" or "external" comparison of business results. Under the internal comparison concept, gross or net profits are used which the taxpayer or a related party has produced in its dealings with unrelated parties in transactions comparable to those under examination. The external comparison concept proceeds in a similar way using data from transactions between parties neither of which is related to the taxpayer enterprise. Both of these methods can also be used to identify areas which warrant special attention in an ongoing examination.

(b) As a second step the Regulations mention the combined results of connected business operations and their apportionment to the individual business operations within a group of enterprises. The use of these figures is permitted for the back-up purposes and the "zeroing-in" on critical areas of transfer pricing just mentioned. Supplementary criteria for the income allocation can, for instance, be usefully collected from amounts so apportioned where, due to pricing regulations in the marketing area or the steady devaluation of the currency used for pricing the product, the sales affiliate, over an extended period of time, shows positive results whereas the manufacturing corporation is left with dwindling profits, and finally negative results, as production costs increase. As the regulations provide for combining the results of connected "business operations" they make for a sufficiently large scope for discretion in choosing whether the results from one product , a product line, an entire corporate division or other economic entities should be used in the apportionment. The alternative between "business income" (which is combined and apportioned) and "non-business income" (which is allocated directly) under some states' unitary tax laws seems to be a somewhat coarser and more rigid dividing line, which may not allow distortions to be avoided to the extent possible under the standard of the German Regulations.

(c) As a third step the Regulations permit the income allocation to be based directly either on the internal/external comparison of business results mentioned under (a) or on the combined results of connected business operations and their apportionment to the individual business operations. This, however, is only possible where

– under the special circumstances of the case the standard methods do not produce satisfactory results (e.g. where due to a high degree of vertical integration of any business active in the industry only insignificant quantities of certain raw materials or intermediary products are traded between unrelated parties before the stage of marketing the finished goods to the final consumer);

– for lack of more meaningful data an estimate (e.g. under Para. 1(3), International Tax Law) is required; or where

– the transactions are so unique to groups of enterprises that they are either simply non-existent between unrelated parties or, if they are encountered outside, are conducted in a way that their commercial content is essentially different. In this last situation, Para. 2.4.6. of the Regulations, in addition, provides for the possibility of apportioning the income from the overall transactions under the fairness standards of sound business management.

The nuances between the various alternative methods and the preconditions for their use may look academic at first glance. Although no experience from their practical application (and from possible litigation) is yet available, it appears fair to say that their role as a method of last resort is an important factor in ensuring that the arm's length standard is not readily discarded whenever things become complicated. The flexibility built into these rules can be expected to be equally helpful for the avoidance of any extra-jurisdictional taxation and for accommodating solutions obtained by means of cooperating with major treaty partners.

d. Alternative methods under Italian law

Under Chapter III, Part 4a of the Italian Transfer Pricing Provisions,[43] a possible alternative method is the allocation of overall profits accruing from a sale, or number of sales, made between two associated companies. Under this method, the consolidated profits are allocated pro rata according to the costs borne by each of the companies involved. The Provisions expressly recognize the fact that such a profit split takes no account of market conditions and the economic standing of the enterprise, and that such a deviation from the principle of fiscal autonomy of each enterprise is only acceptable if, based on an international agreement, timely coordination with the treaty partner is achieved which ensures an equitable allocation of the overall profits between the countries involved.

Chapter II, Parts 4b, 4c, and 4d of the Italian Provisions contain further rules for alternative approaches, which are similar to those under the German Regulations (comparison of gross profits, profitability of invested capital, gross margins of the economic sector).

e. Less developed countries (LDCs)

There are only very few cases of LDCs which use a combination and apportionment system similar to the type discussed under 1.a-1.d with respect to non-residents or resident affiliates of foreign entities. According to Sec. 2(3) of Ghana's Income Tax Decree 1975, the profits of a branch, subsidiary or associated company of a non-resident company are deemed to be not less than the proportion of the total profits of the whole group of companies, both resident and non-resident, that the turnover of the company in Ghana bears to the total turnover of the group; the Commissioner may, however, where he is satisfied with the results of the Ghana branch or company, compute its profits without reference to the total group profits. In addition, according to Sec. 9(2)(b) non-arm's length dealings between controlling and controlled companies or persons are deemed to be artificial or fictitious, and the Commissioner has the power to disregard such transactions.

Under Chilean law, the Chilean source of income of a domestic branch of a foreign entity may be determined either by applying to the branch's gross receipts the same ratio which exists between the gross receipts and the net income of the enterprise's head office, or by applying to the branch's overall assets the ratio between gross assets and net income of the head office, provided that the

43. For an English translation, see Studio Trivoli (1981).

branch's accounting records are inadequate to determine the economic results of the branch's activities.[44] This precondition as well as the possibility, in the case of Ghana, of basing the tax claims against the domestic entity on its own income rather than on the combined group results (possibly in conjunction with adjustments for non-arm's length transactions) show that these rules cannot be characterized as straightforward and cogent unitary schemes. They are a mixture of alternative methods and menacing stick meant to increase taxpayer compliance domestically.[45] It is difficult to ascertain how much leverage these provisions create in practice.

LDCs would probably find themselves in a dilemma trying to improve their ability to implement unitary approaches by means of a tax treaty: on the one hand, such a treaty would normally include an exchange of information clause and would therefore theoretically give the LDC assets to some of the figures needed to compute group sales, income, assets, etc. On the other hand, an industrialized country as a potential treaty partner would most likely seek to incorporate in the double taxation agreement language that would correspond to the arm's length standard of the OECD and UN Models. In the absence of concessions, such a treaty rule would supersede any unitary concept contained in the LDC's national law if used as a prime approach of income allocation and would leave room for the "indirect method" only as an auxiliary yardstick to delineate branch income.

In order to avoid the difficult task of evaluating factual circumstances abroad, LDCs, in order to safeguard their interests as capital importing and source countries, rely heavily on tax schemes which are administratively easy to implement. A fair amount of LDCs' source taxation is based on figures which are readily available and verifiable within the territory of the taxing jurisdiction, i.e. gross sales, receipts, or billings. Sometimes this tax base includes receipts for activities which, economically, do not involve the territory of the taxing jurisdiction at all. In the Philippines , for instance, foreign carriers are taxed at 2.5% of their gross Philippine billings. As opposed to cargo and mail transports, services performed in consideration of the ticket price need not involve operations to and from Philippine territory in the case of passenger transportation; the mere fact that the ticket was sold there is considered sufficient nexus for the power to tax.

Such practices can be viewed under several angles: they amount to a (gross) sales tax (as opposed to a (net) value-added tax) which does not follow the internationally accepted destination principle, in view of the fact that no relief is granted for amounts paid in consideration of service performed abroad. It can also be construed as a flat-rate schedular tax on domestic income, with such income being arrived at by applying a fixed percentage for imputed expenses as a deduction from gross income.[46] It is interesting to note that the Philippine Tax Code, before the change to a gross income approach occurred, contained provisions which allowed as a deduction from gross Philippine-source income earned by foreign steamship companies a portion of the foreign company's world-wide expenses and losses from comparable activities. The portion was determined by using a sales ratio, i.e. Philippine-source income over world-wide receipts from all ports of all vessels, including receipts incidental to the shipping industry. Due to the lack of verifiability of these data, which were located abroad and were not comparable as they were reported to different tax jurisdictions, this unitary approach to cost allocation, on the basis of the so-called "Massachusetts Formula", was abolished.

Other countries use systems predicated even more distinctly on schedular traits. At the same time, such tax systems can often be assimilated to taxes on gross receipts. A case in point here is the Venezuelan formula calculation of presumed income. Under this system differential percentage rates are applied to gross revenue from different types of income, and varying withholding tax rates are then applied to these amounts, in taxing non-resident corporations or individuals. The problem with these taxes is twofold: relief measures (e.g. a foreign tax credit) by residence countries will often require the identification of the net income which is sourceable to the LDC, based on an arm's length standard in the case of branch income, or otherwise, a test of economic connection of both receipts and expenses with the activity carried out in the source country. In the residence country's view certain taxes, although designed in an effort to approximate net income computation either by a low tax rate or by a percentage imputation of expenses, are ineligible for relief altogether because their sales tax characteristics are considered to be predominant. In less serious cases, a clash will occur between the source rules of both countries if the nexus for the LDC's tax claim is a weak one (Philippine example) or if the LDC goes overboard in its extra-jurisdictional claims, e.g. because income arising from the mere delivery of goods to customers in the foreign country is taxed.[47]

3. Results of formula apportionment and unharmonized approaches for the international income allocation

The following, substantially simplified, example[48] shows the distortions which can arise when formula apportionment is used, due to differential levels of profitability, labor cost, and business volume. A bank has its head office in country HQ. Its debt claims acquired and held in HQ yield an average interest of 10%, which is higher than normal rates in HQ's market because the bank specializes in highly risky but so far successful lending activities. Because of a favorable banking legislation and an over-liquidity position of risk-averse investors in its market area, HQ can borrow at low interest rates which leave it with the tremendous gross profit margin of 25% of receipts. The bank's only branch in country BR operates in a less favorable environment. The average interest which its debt claims yield is 8%, partly because banking regulations require the branch to stay out of last-

44. See also Casanegra de Jantscher (1980), p. 22.
45. See Mutén (1980), p. 10.
46. See "The Philippines: Recent Developments and Problems Relating to the Taxation of Multinational Corporations" (1983), p. 366.
47. This type of *Liefergewinnbesteuerung* occurs frequently where assembly projects are undertaken, although the problem is not limited to this situation.
48. See also Chart II.

resort lending. The minimum reserve requirements of BR have increased the costs of funds borrowed to an extent that the branch's gross margin is "only" 20% of receipts. And because of all the red tape involved in running a banking business in BR, along with the tough competition for new customers with a good credit standing, its personnel costs are comparatively higher than those of the head office: although HQ's debt claims are well over three times as high as BR's, HQ's personnel costs are only slightly more than double of what BR has to spend.[49] All lending and borrowing by both BR and HQ is conducted with unrelated parties at market rates.

The computation of the profits of the banking enterprise based on the arm's length principle reflects the higher profitability of HQ and allocates to it 90% of the overall profit. If the sales ratio is used, that portion drops to 80%; this is primarily due to the fact that the market forces in HQ, which account for HQ's low borrowing rates, are not reflected in the volume of lending. If the assets ratio is used, HQ's share drops by another 4 percentage points because the relatively high yield (25% higher than that of BR's yield) carried by the debt claims is not reflected in their respective size. If the payroll ratio is used, HQ's share drops to 70% of profits because of the relatively higher cost of manpower in BR. Without having to refer to the payroll cost per employee, the payroll cost differential can be explained as follows: HQ acquired some 40% more assets per dollar spent for personnel and its staff generated over four times as much profit per manpower dollar spent than BR. If an equal-weight sales-assets-payroll factor is used, roughly the same profit apportionment occurs as under the assets ratio. Lines 6, 8, 10, 12, and 14 of Chart II show the changes in profit-over-turnover ratios depending on the apportionment formula used.

Supposing BR's tax administration proceeded to tax the branch under any of the non-arm's length methods mentioned in Chart II, the resulting changes in apportioned profits will be of concern not only to the bank but also to HQ's Treasury as the bank will probably ask its tax authorities to exempt more branch income or to grant additional foreign tax credit. If both countries can agree on a uniform approach, the bank is not likely to complain if taxes in BR are not considerably higher than in HQ. If BR insists on the use of the unitary approach, and HQ is not inclined to reduce the income computed under the arm's length method correspondingly, double taxation occurs. As shown in Chart III, the effects of double taxation ("overtaxation") based on a 50% average tax rate in HQ and, initially, also in BR ("BR(A)") would be eliminated if BR, simultaneously with the changeover to a unitary tax system, lowered its average tax rate ("BR(B)") by approximately one half or three quarters, depending on the apportionment formula used. BR would then still be confronted with the criticism that double taxation of income persisted under its tax system, but the bank would not be exposed to any greater tax burden world-wide than before the change. The same revenue as under a unitary system along with a 50% tax rate would accrue to BR if it abolished net income taxation of non-resident corporations altogether and introduced a tax on gross receipts accruing to domestic entities (including branches). Column 10 of Chart III shows the tax rates necessary to generate the same amount of revenue. Assuming that the new tax on gross receipts was not in itself discriminatory, BR's government would not be exposed to the criticism of creating double taxation contrary to an existing tax treaty. Double taxation would occur between income taxes and taxes on gross receipts (turnover) to which any conventional income tax treaty be-

49. In the example, expenses other than payroll and assets other than debt claims are disregarded for simplification.

Chart II

	World-wide	HQ	BR	Share in profits (HQ/BR) according to arm's length	sales ratio	asset ratio	payroll ratio	3-factor ratio
(1) Assets (debt claims)	52,500	40,000	12,500					
(2) Interest received	5,000	4,000	1,000					
(3) Interest payable	3,800	3,000	800					
(4) Payroll expenses	400	280	120					
(5) Allocable profit *arm's length*	800	720	80	90/10				
(6) Profit/turnover		18%	8%					
(7) Apportioned profit *sales ratio*	800	640	160		80/20			
(8) Profit/turnover		16%	16%					
(9) Apportioned profit *assets ratio*	800	608	192			76/24		
(10) Profit/turnover		15%	19%					
(11) Apportioned profit *payroll ratio*	800	560	240				70/30	
(12) Profit/turnover		14%	24%					
(13) Apportioned profit *3-factor-ratio*	266	213	53		80/20			
	267	203	64			76/24		
	267	187	80				70/30	
	800	603	197					76/24
(14) Profit/turnover		15%	20%					

Chart III

Income allocation In HQ	In BR according to	Profits earned w-w (1)	Doubly taxed in add. (2)	Taxable profits HQ (3)	Taxable profits BR (4)	Tax 50% HQ (5)	Tax 50% BR(A) (6)	Total tax w-w (7)	Result over-taxation (8)	No over-taxation if BR(B) is (9)	BR gets same revenue as under col. 6 if gross rec. taxed at (amount col. 6 ./. 1,000) (10)
arm's l.	arm's l.	800	0	720	80	360	40	400	0	—	4.0%
arm's l.	sales r.	800	80	720	160	360	80	440	40	25.0%	8.0%
arm's l.	asset r.	800	112	720	192	360	96	456	56	20.8%	9.6%
arm's l.	payr. r.	800	160	720	240	360	120	480	80	12.5%	12.0%
arm's l.	3-fact. r.	800	117	720	197	360	98	458	58	20.3%	9.8%

w-w = world-wide

tween HQ and BR – in the absence of special bilateral arrangements – would not normally apply.[50] The resulting over-taxation of the bank would depend on the method of avoiding double taxation under the treaty. If HQ exempts BR-branch income, the resulting world-wide tax burden is equal to the situation under a unitary system in BR with a 50% tax rate. If the treaty is based on the foreign tax credit method, HQ may not[51] grant the same if it views BR's levy as a sales tax.[52] The bank would then have to pay additional domestic taxes to HQ on its foreign branch income; in computing it, the bank would probably be able to deduct BR's tax as an expense.

These alternatives point to two aspects of unitary taxation: (1) While a unitary system does not necessarily increase the overall tax burden for a multinational, compared to an arm's length country, it can have the effect of a surtax on multinationals in the country of its application. This is shown in Chart III: while the lower nominal tax rates in column 9 economically amount to a 50% tax rate on the BR-source arm's length profits of the multinational bank (due to the income situation of that bank outside of BR being taken into consideration), they do not constitute the same high burden for businesses which are only active within BR's territory. (2) Taxes on gross receipts can have the same revenue results as a unitary tax, yet can be designed without reference to elements located outside the taxing jurisdiction, thus avoiding the discriminatory penalties for "being multinational".

The example also shows that unitary taxation could work to the disadvantage of a taxing jurisdiction: if it were country HQ instead of BR which were to change over to a formula apportionment system, this would considerably reduce its part of the overall tax claim due to the combination of its profitable domestic taxpayer's income with that of a less profitable foreign business entity. Furthermore, a considerable bonus would be awarded to the multinational taxpayer if BR maintained an arm's length standard while HQ was adopting unitary apportionment, as the uncoordinated simultaneous application of both concepts would lead to double-exempted income internationally. In country HQ the discrimination would then be a vis-à-vis non-multinationals, which would not enjoy the blessings of consolidation with foreign loss-making entities ("international group relief").

III. UNITARY TAXATION: AN ALTERNATIVE FOR LDCs?

As previously mentioned, full-fledged unitary systems as a first approach to international income allocation have not been adopted by LDCs. There are, however, indications that this situation might change in the future. At least two developing countries, Kenya and Egypt, have taken steps bilaterally to safeguard their power to use unitary approaches. In the case of Kenya, this was done by including the equivalent of Art. 7(4) OECD Model 1977 into the new income tax treaty with Canada. Any decision by an LDC as to whether it should depart from

50. Art. 2 of the OECD Model 1977 does not address the issue explicitly as to where the borderline between the two types of taxation should be drawn. Para. 3 of the Commentary on Art. 2 seems to suggest a fairly broad understanding of income taxes as it includes, for example, the German *Lohnsummensteuer*, a component of the trade tax base which has been abolished in the meantime due to its "job-killing" effects in times of recession.

51. Under proposed IRS-Reg. Para. 1.901-2(b)(4), the tax, in order to meet the "net income requirement", would need to provide for a reduction from gross receipts to permit the recovery of significant costs and expenses attributable to such receipts, or for other compensation as a proxy to such recovery. A gross "bank tax", according to Para. 1.901-2(b)(4)(iv) example (1), would not satisfy the net income requirement. A foreign tax credit might nevertheless be available if other income taxes are generally applied, the bank is exempted from them, and taxation on a gross basis occurs "in lieu of income taxes"; see IRS-Reg. Para. 1.903-1(a).

52. According to Mutén (1982), pp. 263 (266), assumed or minimum profits taxes, based on some percentage of turnover, would qualify as profit taxes if they affect only part of the market participants so that the price finding mechanisms of a specific market could in theory remain free of distortions engendered by the need of those firms which are exposed to turnover-related assessments to shift the tax burden through their pricing.

the international consensus already reached would have to be based on a thorough weighing of the weaknesses of arm's length taxation against the possibility of improving the LDC's position by choosing world-wide formula apportionment as an alternative.

Rationale of transactional approach of arm's length

An alleged theoretical weakness of arm's length is that it was to work with the false assumption that a market price can always be established whereas unitary apportionment can do without this assumption as its computations are based solely on data derived from transactions with unrelated parties. Along the same lines, some view world-wide combination and apportionment as the more straightforward economic approach as it need not take recourse to an "as if" determination of constructive or fictitious prices where the painstaking task of price comparison, and price adjustment to make allowances for dissimilarities, between the transfer and the market price has not lead to a satisfactory result. By taking into consideration only transactions between truly unrelated businesses, it is argued, unitary methods adequately deal with the economic reality that intercorporate transactions generate no real economic gain or loss.

It is true that finding a comparable price or, at least, profit margin in a certain market or industry becomes increasingly difficult, and the constraints of arm's length become more obvious the less standardized and the more sophisticated a product or a service is. However, economic reality also shows that groups of enterprises are often organized in such a way that their freedom to shop and transact outside the group – even where the same or similar products or services are available from affiliates – can be quite considerable if not unlimited (so-called "profit-center approach").[53] In such a situation, intra-group transfers do lead to genuine gains or losses and should not be disregarded a priori. The main task of the examiner may then shift from price finding and price comparison to the thornier issue of allocating overhead expenses or central costs for intangibles, as the group member, while freer in its decisions in one area, may be subjected to "corporate loyalty" in another and may be required to make use of certain group transfers to enhance economies of scale.

One of the areas in which a certain degree of artificiality in the arm's length standard cannot be denied is that of enterprises economically unable to exist without group affiliation. An example for situations of this kind is given in the OECD Transfer Pricing Report:[54] it may occur that the members of a group are so specialized in their activities and so closely integrated into the production of a range of products that all of the products are needed for the group to make profits overall; however, only some of these products would be profitable to produce on an arm's length basis and some would not.[55] If a group member in one country produces only the loss-making products in the range whereas profitable goods are produced elsewhere, the arm's length approach to correcting this situation for tax purposes would be to compare the position of the loss-making affiliate with that of an independent party; if the latter continuously were to make losses by charging market prices it would be viewed as producing not for its own benefit but for that of others. This activity of the affiliate is then construed to be of service to the rest of the group for which an adequate fee – over and above the sales price for the product – would be chargeable. This transactional approach would appear to be somewhat fictitious and incongruent with economic reality.

A more realistic equivalent in a market situation would be that of a contract manufacturer. Under this approach a fair manufacturing profit on a cost-plus basis would be allocated to the subcontractor with its limited range of production, and the marketing operation would be deemed to take place under a buy-back arrangement with the entity controlling the various group members and marketing the final product. Possible losses from acquiring the product at subcontractor's cost-plus price and selling at a (lower!) market rate would then be set off against the revenues from more profitable products having taken a comparable route. The various subcontractors would then be left with a profit level commensurate to their functions. The weakness of this scheme would be, however, that only the central entity would be fully exposed to the ups and downs of market forces, whereas the subcontractors' mark-up on cost would have to reflect the functions performed by independent subcontractors of the same industry. Hence, the mark-up would not necessarily reflect the average earning power and profitability of the group as a whole. Because the entity performs contract manufacturer functions as an integral part of the group "for better or for worse", the unitariness of the business would economically appear to warrant some kind of profit split, care being taken that the use of apportionment factors does not have distortive effects internationally.

The example shows that the arm's length principle, due to its transactional approach, may well "stand in its own way" when it comes to cases which economically call for unitary treatment but where the availability of data from third-party arrangements makes it difficult to justify such treatment. These obstacles would appear to be of a more serious nature where rules for the application of the arm's length standard prescribe a definite sequence of methods to be used, such as IRS-Reg. Para. 1.482.

2. Systemic deficiencies of unitary apportionment

While proponents of arm's length would therefore need to admit that in certain situations unitary approaches may economically be a more adequate tool to deal with highly integrated and interdependent enterprises, it must be pointed out that under the existing unitary systems important practical pitfalls exist with respect to identifying just those cases for which unitary profit splits would adequately reflect the inseparability of business

53. Casanegra de Jantscher (1980), p. 5.
54. Para. 42(e).
55. A practical case would be that of a group producing and marketing brand-name automobile tires. Its customers expect the outlets of the owner of the trademark to carry, and have available at short notice, all sizes from truck to compact car. Only a certain cross-section of medium sizes are profitable because they can be produced in sufficiently large numbers. These products have to recoup the costs for the slow-moving stock-in-trade on both ends of the product range.

activities. In order to pay due regard to the high degree of diversification that many multinational businesses have reached, the definition of "unitary business" would have to use far more sophisticated criteria than those presently available. The U.S. Supreme Court decision according to which not all group members, in order to be included in the unitary business have to be unitary vis-à-vis every other group member so included[56] would appear to be a standard of a low degree of precision and conducive to serious distortions internationally. An economically realistic grouping of unitary versus non-unitary members, based on more concrete criteria[57] than a mere ownership test, the existence in general of economies of scale through shared facilities, the vague test of "flows of value", etc., would, however, presuppose complicated functional analyses with respect to all world-wide entities which might possibly qualify for inclusion. An LDC, already faced with considerable problems in applying an arm's length test on a transactional basis, would need to go into far greater scrutiny with respect to foreign business entities, which may not be linked to the LDC-based entity transactionally but possibly functionally via several other interposed group members. The constraints of administrative simplicity would therefore require fairly coarse standards for delineating the scope of a unitary business, which, in turn, would be conducive to avoidance techniques.

3. Legal and economic uncertainty

Another argument frequently raised against arm's length taxation is that it leaves corporations with a high degree of uncertainty concerning their pricing and creates unproductive costs to both corporations and tax officials. Unitary taxation, in contrast, is supposed to reduce the uncertainty because the factors leading to the ultimate profit attribution are known beforehand so that once a business is determined to be unitary all administrative discretion is removed.[58]

For an LDC the aspect of uncertainty would appear to be of concern from both an economic and administrative viewpoint. The economic consideration is that its tax regime would need to complement other measures and economic policies aimed at attracting investment. When generous tax holidays and accelerated depreciation are granted this will only attract the fly-by-night type of investor if at the conclusion of the start-up period tax burdens are unforeseeable and erratic. The future investor would be better off knowing that he will be subject to a fairly high but determinable tax claim than having to reckon with a multitude of factors which will influence his tax base. In this respect arm's length, for a number of reasons, appears to provide for economically more sound terms of reference than unitary taxation.

a. Origin of data used for arm's length and unitary taxation

Arm's length pricing is based on data generally available in the relevant market and to which business management of the enterprises involved in the transaction has access or to which it may be expected to have access if acting bona fide.[59] Where quoted market prices are not available , but at least mark the upper and lower limits of a price range, a consistent pricing policy will not be subject to adjustments – just because the "exact" price was not used – unless the enterprises involved exploit the situation by fixing the price schematically at the lower or upper limit of the range without sound business reasons.[60] A realistic assessment of arm's length pricing, however, cannot overlook the fact that an LDC will often simply have no market besides the transactions under consideration. Price determination based on market data will be even more difficult with respect to intangibles and services. Requests for information and administrative assistance will often be a means of last resort, though no guarantee for success. The LDC, although it could theoretically use market or market-derived data in calculating a net profit for the entity in its jurisdiction, will therefore have to rely heavily on taxation on gross receipts.

It would, however, be a mistake to assume that this situation would drastically improve if a unitary tax system were adopted. Unitary taxation works with data which need not have anything to do with the respective market, e.g. because a group member executes no other than intra-group transactions. For instance, one function typically assumed by LDC-based entities, whose labor costs are relatively low, is that of a contract manufacturer. Both the purchase and the sale of the goods processed may involve controlled transactions. In calculating the apportionable tax base under today's unitary systems none of the market data obtaining in the LDC's jurisdiction would be a factor as all intra-group transactions have to be eliminated. The same would be true for the sales factor in the apportionment formula as the LDC has no third-party transactions.[61] The only relevant data derived from the LDC's entity are assets, if any, and payroll. All other factors to be included will come from business dealings which may occur in different parts of the world under market conditions totally alien to the LDCs market and not verifiable through administrative assistance as LDCs tend not to dispose of extended treaty networks. The LDC under a unitary approach would therefore typically not be in a position to use figures which are readily available and verifiable within its territory as crucial elements of its systems,[62] whereas such information would be of certain value, e.g. in the previous contract-manufacturer example (price determination on a cost-plus basis).

From the standpoint of a future investor in an LDC, the example of the Royal Dutch Shell case,[63] in which the

56. See Container Corporation v. Franchise Tax Board, State of California.
57. For a three-level test to be applied in determining unitariness, see McLure (forthcoming).
58. See Harley (1981), pp. 1563 (1567).
59. See Para. 2.1.8. of the German Administrative Transfer Pricing Regulations, *Federal Tax Gazette*, Part I (1983), p. 218.
60. Id., Para. 2.1.9., example 1.
61. Mutén (1980) seems to infer that "non-arm's length" export sales would be subject to the "risk of underpricing". Under a unitary system such as that of California, controlled sales would be totally excluded from the sales factor. See WhiteNack (1983), p. 771, footnote at asterisk.
62. II.2.e. above.
63. See Shell Petroleum NV v. Franchise Tax Board, State of California, No. C 81 4302 MHP (N.D. Cal.).

California affiliate was required to combine the income of some 900 other group affiliates world-wide before apportionment, demonstrates quite well of how little certainty the business management of the California affiliate involved in conducting day-to-day business dealings can avail itself under a unitary system, e.g. when estimating future tax costs for third-party price determination.

b. Elimination of administrative discretion

The alleged advantage of unitary taxation eliminating administrative discretion which some view as inherent to arm's length does not appear convincing. The decision as to which entities' income should be combined in a unitary business involves considerable judgment in the absence of hard and fast rules based on ownership or certain percentages of transactional links. On the other hand, it is true that, as opposed to arm's length, under a unitary system the difficult task of allocating overhead, general administrative costs, or centralized services need not be addressed as these figures are "self-adjusting" due to the formula apportionment. This simplification, as welcome as it is in a water's edge system of combination and apportionment, can lead to terrific misallocations internationally as no consistent application in the countries involved would be possible in today's tax world in order to overcome economic incomparability of apportionment factors.[64] Even if central group management submitted to all administrations concerned a uniform world-wide concept[65] which would help eliminate overlaps and gaps in tax claims, the unitary state would not be in a position to even consider such a concept as it would have to disregard all intra-group transactions. A proposal offered by proponents of unitary apportionment to avoid international distortions would be to adjust apportionment factors by using comparability tables and indexation. Here, too, considerable judgment – no less than in arm's length overhead allocation – would be involved in establishing the necessary degree of comparability between a multitude of group members, all of which factors would need to be put on an equal footing.

c. Eliminating the effects of currency fluctuations

The impact of currency fluctuations, which would influence both the computation of combined income and of apportionment factors, for all of which a common unit of measurement has to be found, appears to be of greater importance under unitary than under arm's length approaches and would appear to reduce the predictability of tax claims under the former method.

On the level of adding combined group income, the question as to what currency should be used as a common denominator needs to be resolved. The assessing country would naturally require the computation to be based on its national currency, but other jurisdictions would not be very likely to follow suit.[66] If the currencies involved are both strong and weak ones, a multinational might well show global profits in the depreciated currency and losses if it reports in the appreciated one,[67] and this might be due exclusively to currency fluctuations and would not necessarily presuppose varying levels of profitability in the various entities' economic activities which generated the combined income.

In intra-group transactions involving foreign currencies a criterion to be considered under arm's length standards (one which is of no concern under a unitary approach) would be whether the parties to the transaction equitably distributed the exchange risks among themselves, i.e. in a way which independent parties would also have agreed to.[68] If the parties therefore do not illicitly exploit this discretionary scope in order to reduce their overall tax burden, their hedging and forward exchange measures are likely to produce more predictable results than under a unitary approach, where similar measures would not appear to have any mitigating impact on how volatile exchange rates affect the factors used in the apportionment formula.[69]

d. The administrative dimension

The administrative aspect of the determinability of the resulting tax burden has already been touched upon in the context of delineating the scope of a unitary business. Another practical consideration of even more concern to LDCs would be that of securing a realistic degree of compliance. Coming back to the typical example of contract manufacturing by an LDC entity, the relatively straightforward transactional pattern parent-subsidiary-parent would be the subject of a tax examination under an arm's length approach. Conversely, the enterprises involved would need to be prepared to furnish information relevant to these entities. Under a unitary approach the information necessary to arrive at the taxable base would involve a considerably larger volume of data, depending on the size of the group and for what degree of precision the examining authorities are trying. As their ambitiousness will invariably clash with feasibility constraints, a certain amount of administrative discretion will need to be applied in the decision as to what and how much information and documentation is to be submitted. It is not clear that unitary approaches would offer a distinct advantage over arm's length taxation in this respect.

4. Revenue considerations

Unitary taxation may appear attractive to LDCs with a view to its revenue results. Although it is about as difficult to compile aggregate data on the differential tax effect of currently applied unitary state taxation compared to separate entity approaches as it is to comply with that tax, certain mechanisms are likely to work both to the short-term advantage and long-term disadvantage of an LDC.

(i) As unitary taxation cannot adequately deal with the economic results of start-up or expansionary phases, an LDC business entity of a group which is already successfully active world-wide and is expanding its business into

64. See Kopits and Mutén (forthcoming), p. 7.
65. Such as a cost sharing contract; see Part IV.
66. See Kopits and Mutén (forthcoming), p. 5. For a more optimistic vision of "world taxation" by single assessment and allocation by the home country's administration, see Plasschaert (1981), p. 414.
67. See Mutén (1982), p. 9.
68. See Paras. 3.1.2.1. and 4.2.3., German Administrative Transfer Pricing Regulations, *Federal Tax Gazette,* Part I (1983), p. 218.
69. It is unclear how measures to reduce exchange rate fluctuations are technically treated by the administrations currently using unitary means in the context of calculating the sales factor.

an LDC's market would show positive taxable income from the outset although, economically, it would have to get past a period of increased costs and reduced receipts before reaching a stable market position after the investment phase.

(ii) In the long run the revenue result is likely to turn into a disadvantage for the LDC. Listening to the arguments against U.S. state taxation which investors from industrialized countries have raised, one must conclude that the likelihood of state unitary taxation resulting in an overstatement of state-source income is just as great as the propensity of unitary apportionment to lead to an understatement of an LDC's share in the income. This is due to the factors used in the apportionment of worldwide income and the imbalances which exist between the values of factors and their respective costs between industrialized and developing countries.[70] If it takes four times the value of assets and twice the amount of sales and payroll to generate the same profit within the United States as in a developing country,[71] an equal-weight three-factor formula would only apportion less than 30% of the total profits to the LDC. This would be out of line with economic reality as multinationals have to allocate a fairly high return to their LDC pricing in order to account for the risk factors involved.[72] This risk premium would result in a high mark-up on, for example, costs of goods sold and would be reflected in the sales carried out by the LDC entity. If, however, the LDC-based entity's transactions are only controlled transactions, not even the sales component of the apportionment formula could result in a commensurate apportionment of group income to the LDC as only third-party sales would qualify for inclusion in the sales ratio.

(iii) The revenue results of unitary taxation for LDCs would therefore only work to the LDC's advantage during a limited start-up phase.[73] Collecting this revenue would, however, not be of prime interest to the LDC and could even be counterproductive to other measures intended to attract business and investment, such as tax incentives.[74]

5. Administrative burden

The administrative burden which an LDC will have to face in applying arm's length or unitary approaches and which has already been discussed to some extent can be summarized as follows. In order to contain a fairly high potential of tax avoidance through controlled transactions a representative sample of intra-group dealings needs to be examined under the arm's length standard and a corresponding force of trained manpower will be required.[75] Proponents of the unitary system claim that less monitoring than under arm's length will be required as all intra-group transactions are disregarded. However, reporting, combining, and apportioning worldwide group income – along with defining the scope of the unitary business – represent a tremendous compliance task to the taxpayer; unless this compliance burden is matched by efficient control mechanisms, statutory compliance rules will be viewed as a paper tiger and as an invitation to abuse. The same is true if measures designed to relax compliance, and correspondingly to simplify the administrative burdens, are taken, e.g. by relying more heavily on financial reporting mandatory under various countries' commercial codes, stock exchange supervisory laws, and similar publication and filing requirements.[76] Such a practice would add another dimension of uncertainty and incomparability in the absence of worldwide harmonized accounting standards. Administrative problems would grow even more if the proposal to refine and improve on today's unitary systems were followed up, say, by introducing more elaborate rules on the scope of the unitary business. Due to the world-wide dimension of unitary audits – as opposed to the transactional scope of an arm's length audit – examiners would be tied up in considerably more work in obtaining or verifying data needed to reach satisfactory results.

6. Tax havens

The problem of counteracting tax evasion and avoidance is of foremost importance to industrialized countries, especially where income is channeled through a tax haven in transactions originating and ending in high taxing jurisdictions. Developing countries which have been able to attract investment and to modernize their tax administrations are beginning to face similar problems. Proponents of the unitary standard argue that arm's length helps to reinforce the insulation effects of tax haven corporations; to counter it, special "look-through" provisions, often extremely complicated, are required. As the most important effect of unitary taxation is the elimination of deferral and the piercing of the corporate veil, it is felt that special provisions such as those in Subpart F of the Internal Revenue Code or in the German International Tax Law (Aussensteuergesetz) are superfluous when group income is allocated on a unitary footing. Such reasoning, however, overlooks the fact that unitary apportionment has not gone as far as totally denying the existence of tax haven entities affiliated with a multinational group. Although unitary apportionment does eliminate the blessings of detouring income to a tax haven corporation whose sole function is that of an invoicing agent or conduit company – a result which under the arm's length principle would possibly require involved functional analyses and exploration of the factual circumstances – it cannot totally avoid the attribution of some group income to a tax haven entity where the same deals with third parties. If a considerable volume of third-party transactions on behalf of the group as a whole is done out of a tax haven entity, possibly after some minor functions have been performed there as well which turn the semi-finished product into a marketable good, the tax haven entity is eligible for apportionment, most likely with small amounts for the asset and payroll factors and possible overwhelming amounts for the sales factor. The income attributable under such an approach may well exceed what would otherwise be allocable on

70. See Kogels (1983), pp. 65 (66).
71. According to estimates by industrial circles.
72. See Kopits and Mutén (forthcoming).
73. Id., who suggests a capital-based formula to reduce the negative revenue incidence of unitary taxation for LDCs.
74. Id.
75. Part IV will discuss ways for LDCs to reduce this burden by cooperating with industrialized countries.
76. See Kopits and Mutén (forthcoming).

the basis of a functional analysis using the arm's length standard.

Furthermore, certain unitary methods may make the use of a tax haven recommendable in order effectively to shield income and to counter the elimination of deferral. If the unitary system does not combine all group income but works with the distinction, existing for instance under California law, between "business income" (which is combined and apportioned) and "passive investment" (non-business income which is allocated to its recipient upon disbursement), business income might easily be shielded in a tax haven. The unitary structure would be bisected by putting the ownership in and management of active foreign subsidiaries into a tax haven corporation. The ultimate parent would then hold the stock in that holding and management entity and might occasionally receive non-business income, within the meaning of the unitary provisions, in the form of dividends.[77] In order to crack down on such benefits, unitary taxation would either need to draw on substance-versus-form or look-through provisions (provisions which it supposedly can do without!) or apply fairly coarse ownership tests and waive the distinction between various types of income.

To conclude: an LDC would not be very likely to draw substantial administrative or revenue benefits from the adoption of a unitary tax system as a prime approach to international income allocation. By departing from the arm's length standard, which is backed by broad international consensus, it would decrease the possibility of cooperating with industrialized nations in a common effort to counter tax evasion and to find coordinated standards of income attribution.

IV. COMBINING THE FEATURES OF BOTH APPROACHES

1. Cost sharing as a compromise between two extremes

The main argument of those favoring unitary taxation is that a direct allocation of profits becomes arbitrary where certain structural interdependencies between group members exist which, economically, turn the dividing lines between legal entities into mere silhouettes. Such structural linkage is viewed to exist, for instance, if there are within the group economies of scale (through horizontal integration) or of scope (through vertical integration). Shared costs of management and centralized research and development (R & D) are other examples.[78]

Aside from these conceptual aspects, quite a practical consideration would be to suspect that certain group structures offer a gamut of options that are almost seductively conducive to abuse and too good to pass by.

Proponents of the arm's length principle will readily admit that the direct allocation of costs and other expenses, with respect to centralized administrative services and intangibles, causes tremendous problems of valuation and attribution especially if an attempt is made strictly to adhere to the transactional approach. It would appear to be utterly impossible, both for an enterprise and a tax examiner, for instance, to find an adequate market service fee for each and every time an employee of group headquarters' support division makes a phone call to one of the subsidiaries to pass on information or to give advice. If the caller was not a staff member but happened to be a board member, the decision whether he was acting in that capacity (exercising shareholder functions in protecting and administering the parent's investments) or as an advisor to the subsidiary would complicate the allocation problem. The other extreme would be totally to disregard such intra-group activities and apportion expenses related thereto along with all other expenses by reference to sales, payroll, and assets, irrespective of the degree to which one or the other group member benefited from centralized services.

A possible compromise between the two extremes might be to try and avoid the distortive effects of unitary apportionment without "atomizing" a group center's overhead expenses in an attempt to trace all cost items back to each and every transaction. The main feature of such a compromise, on an arm's length footing, is the treatment of the affiliates sharing centralized services as separately incorporated entities, which are viewed as having severed some of their activities from their own businesses and asked a separate enterprise or a central division to conduct these activities for them. Although the character of such an arrangement under civil law is somewhat foggy, the economic rationale is that of pooled resources. Full-fledged pool arrangements between otherwise unrelated parties might be considered an adequate yardstick for comparison although intra-group sharing arrangements have their specific traits.

2. Rules on cost sharing under German Administrative Transfer Pricing Regulations

Legal provisions which address such cost sharing arrangements with respect to financing intangible property can be found in IRS-Regs. Para. 1.482-2(d)(4). The OECD Transfer Pricing Report describes the practice of multinationals which finance R & D by way of "cost contribution" arrangements. The German Administrative Transfer Pricing Regulations[79] contain fairly detailed rules on cost sharing contracts, the scope of which goes beyond the financing of R & D and encompasses expenses incurred for rendering administrative services. In these rules it is recognized that the allocation of shared costs by apportionment can be accepted if the related enterprises base such apportionment on a contractual framework which satisfies the standards of the regulations, provided that separate attribution of costs to individual services and transfers is too burdensome (Para. 7.1.1.).[80] This prefatory provision points to three important aspects:

(i) the rules on cost sharing contracts are intended to

77. See Whitenack (1983), p. 783.
78. See Musgrave (forthcoming).
79. *Federal Tax Gazette,* Part I (1983), p. 218; see Appendix B for an excerpt which reproduces the rules on cost sharing contracts.
80. Paragraphs quoted in parentheses refer to sections of the German Regulations.

provide for administrative simplicity as well as for less compliance burdens;

(ii) they are intended to address both the recovery of expenses for centralized services by their supplier (income side) and the deduction by their recipients (expense side);

(iii) the fairly detailed rules covering the contractual framework and organizational set-up required for the sharing arrangement to be acceptable are designed in an effort to set high quality standards which, when met, will assure the taxpayer enterprise of non-interference by the tax authorities with thousands of intercorporate transactions. If the taxpayer is not prepared to enter into a cost sharing agreement he is free to use a separate transactions approach. The rules are therefore not primarily intended as a sword of the examiners but as a shield for the taxpayer, provided he follows the rules of the game.

The technique of cost sharing basically involves two steps: compilation of costs incurred in rendering the services, and in creating the intangibles transferred, which come under the agreement; and apportionment of the aggregate of costs to the beneficiaries of those services and transfers.

The first step involves the compilation of all costs actually incurred in and attributable to the provision of those services and transfers covered by the arrangement. The compilation of all eligible expenses in one set of books is essential to avoid problems of the kind described in the Philippine example.[81] The regulations therefore require that costs arising outside a central service entity from complementary or supporting activities of the same kind be aggregated within the central service entity.

A mere estimate of the costs to be shared, e.g. based on a certain percentage of group entities' turnover, will not be accepted (Para. 7.1.2., 3rd sentence). Separate charges, e.g. in the form of a fee or royalty, for services and transfers covered by the arrangement will not be allowed over and above the amount to be shared (Paras. 7.1.3. and 7.3.2.).

In a second step, the costs so compiled are apportioned to users of services or to the transferees of intangibles. Eligible users are those entities in whose interest services are actually provided; eligible transferees are those enterprises to whose commercial activity the R & D undertaken actually relates or will relate and who actually use, or can reasonably be expected to use, the results of R & D (Para. 7.2.1., No. 1). No provision is made for specific factors to be used in the apportionment formula. It is, however, required that the formula reflect the extent to which the taxpayer enterprise actually benefits, or can be expected to benefit, from the results of the R & D which it helps to finance, and from the administrative services provided within the group. A turnover ratio may be used provided it adequately reflects actual or expected benefits.

The arrangement has to be based on a contractual relationship predicated on reciprocity: the contract must establish on the part of the payor a specific right, definite both in nature and scope, to benefit from the activities of the entity providing centralized services, including the right to request services or to give instructions (Para. 7.2.1., No. 2). In order to avoid abuse, the regulations specify that, for tax purposes, cost sharing has to be based on a contract which was concluded beforehand in clear and unambiguous terms (Para. 7.1.5.).[82]

A clause intended to ensure a coordinated application of a cost sharing scheme internationally requires not only the entities claiming shared costs as a deduction but also the entity performing the central services to incorporate the amounts of shared costs in its business accounts and computations of tax liability. For a German entity this would also imply an inclusion of the amounts in the books and records kept for financial reporting because the commercial balance sheet, as a general rule, has a binding effect for the tax balance sheet.[83] Although these requirements do not necessarily ensure an equal treatment of the tax effects of a cost sharing contract by all administrations hosting the parties to the agreement, they would appear to be helpful in avoiding a situation such as the one under IRS-Regs. Para. 1.882-5[84] where one country insists on a formula apportionment of expenses and the other on separate billings for individual services and transfers on a straightforward arm's length footing.

3. Areas of concern for tax administrations; international cooperation

In order to allow cost sharing contracts as a basis for expense deductions, the tax administration responsible for the payor entity must be satisfied that the aggregate of apportionable costs is not excessive, that no double charges are made for the same costs, and that the apportionment formula is equitable. Conversely, an administration in charge of taxing the payee entity, which provides services and conducts centralized R & D, must be convinced that there is no flow of value to the benefit of other group members without fair remuneration. The country hosting the entity which provides the benefits to the rest of the group will normally be in the best position to verify all of the above. Germany, which is both a capital exporting country and one which depends on foreign investment in its territory, hosts about as many affiliates of foreign groups as German parents of multinationals. Its finance administration must therefore take great care to find an appropriate balance between requests for outside help and its own ability to furnish similar information. At the same time, this balance must be reflected in its rules governing the area of cost sharing, as maintaining double standards in the long run would hamper and eventually disrupt international administrative cooperation. In all modesty it might be added that an LDC would not run great risks in trusting a tax administration such as that of the Federal Republic to find and maintain this balance and apply it consistently. In quite practical terms this might be phrased in a recommendation to LDCs:

(i) not to venture into uncharted territory by adopting unitary tax rules; and

(ii) to turn to developed countries' tax examination services in requests for administrative assistance when re-

81. See II.a.e.
82. Para. 10. contains transitional rules.
83. So-called *Massgeblichkeitsprinzip*.
84. See II.2.b.

viewing charges made by parent corporations under cost sharing arrangements with the understanding that, for example, the German administration will not require a German parent to charge off more than it would accept as deductible expenses in the case of payments made by a German affiliate to a foreign parent under a comparable arrangement.

APPENDIX I

Embassy of the
Federal Republic of Germany
Washington, D.C.

November 28, 1983

MEMORANDUM TO THE UNITED STATES DEPARTMENT OF THE TREASURY

on the issue of State taxation by worldwide combination and formula apportionment
("unitary taxation")

The Government of the Federal Republic of Germany is deeply concerned about an increasing international incidence of State taxation in the United States of America with respect to German-based multijurisdictional enterprises. It is the intention of the following memorandum to bring the position of the Federal Government to the attention of the Department of the Treasury so it may take it into consideration when reviewing the unitary tax issue within the Working Group appointed by the President of the United States.

1. Unrelieved double taxation

When a worldwide combination of business income along with formula apportionment is used to calculate a share in unitary group income as a State's tax base, this will invariably attract income or loss elements which were not generated by the State-based entity itself to the State availing itself of such a taxation method. Whether the application of this method results in an advantage or disadvantage for the State, and the multijurisdictional enterprise respectively, depends on the individual case. The best evidence for unitary taxation working either way is the case history available of enterprises litigating both against and in favor of its application before United States courts. Empirical data on the aggregate results of unitary taxation and on the differences in tax costs vis-à-vis arm's length results is just as difficult to collect as it is burdensome to comply with unitary tax rules. These uncertainties inherent to the unitary approach are compounded by the concern that the uncoordinated, simultaneous application of unitary and arm's length concepts internationally will lead to tax claims of the fiscs involved which, in aggregate, do not reflect economic reality. In contrast to a water's edge approach of combination and apportionment, which would appear to constitute a fair compromise between the need for State revenue and administrative simplicity, unitary approaches, when applied in an economically inhomogeneous international environment, result in a serious misallocation of income. If a United States entity of a German group bears increased costs or experiences a temporarily unprofitable situation, e.g. in start-up or expansionary phases or under other special circumstances of competition, an over-assessment in the unitary State (and international double taxation) will be the result because a fair corollary for the partial taxation of foreign income of other – more profitable – group members in the form of a foreign tax credit is not granted.

2. Compliance cost

While the evaluation of the actual overall revenue implications of unitary taxation involves considerable judgment at this stage and warrants further exploration, the compliance cost and the administrative burdens engendered by unitary tax statutes are manifest. Not only will a German multijurisdictional enterprise have to consolidate the accounts of the unitary business entities worldwide – a task which is presently otherwise not required for tax purposes under German or United States federal laws and which is particularly painstaking as the delineation of a unitary business neither follows uniform rules under the various State statutes nor always coincides with corporate structures under commercial law. The enterprise will furthermore have to recalculate the combined reports on a dollar basis and adjust its balance sheet items to accommodate differential State accounting and valuation provisions. These administrative burdens are compounded by the high cost of having foreign accounts certified and the cost of special computations required to determine the various factors used in the apportionment calculation. On the other hand, the verification and examination of the various books and records necessary to ensure full compliance with unitary statutes is well in excess of what would appear to be feasible for a State administration whose aim it is to use its resources in a more productive way than under an arm's length concept. The Government of the Federal Republic of Germany therefore is convinced that, due to these constraints, the administration of unitary tax schemes has to settle for a low degree of precision. It may often have to take recourse to rough estimates and this may even become the normal procedure in the majority of cases. Furthermore, the multijurisdictional enterprise, with respect to compliance cost, is at a disadvantage when compared with a United States based multijurisdictional group which has no part of its unitary business abroad or whose compliance on a dollar basis will be less burdensome.

3. Direct investment hampered

The Federal Government emphasizes the fact that German enterprises which have to face the likelihood of double taxation and the compliance cost caused by unitary taxation will have to take their business and investment decisions with a view to the rather mixed tax environment created in the United States by the various forms of State taxation. Tax-induced misallocation of resources both within the United States and internationally is unavoidable if no satisfactory solutions to these impediments can be found. Capital and trade flows between our two countries will be distorted and, to a certain extent, possibly disrupted if the competitive disadvantage of "being multinational" as opposed to "just domestic" is exacerbated instead of reduced by the introduction of unitary statutes by more State legislatures, and a failure to eliminate their negative international impact in those States where they already exist.

4. Setback for international consensus

In the past, the free flow of investment capital and trade between the United States and the Federal Republic of Germany has been imbedded in a bilateral tax environment which cannot be viewed in isolation of international developments. The international community has endeavored for decades to create an international tax system that avoids barriers and distortions and gives adequate protection to international trade and investment. In multilateral discussions first initiated by the League of Nations a consensus has emerged – among developing as well as industrialized countries – in favor of the arm's length principle of taxation. The Federal Republic of Germany and the United States have contributed actively to these endeavors. The unitary approach to taxation of foreign-based enterprises runs counter to this consensus and may be the beginning of its disruption. A failure to bring this development to a halt and to eliminate the international incidence of unitary taxation might lead the international community to conclude that the United States has ceased to speak with one voice and thus is no longer contributing to the international tax order toward which the United States, the Federal Republic of Germany and other nations have worked for so many years. Other countries may follow the practice of unitary State taxation – and there are signs that some of them have already taken steps to safeguard such moves bilaterally – if the conflict with the developed international consensus is not resolved soon. Such a danger of disruption of the international consensus through inaction is a matter of great concern to the Federal Government, irrespective of whether the negative impact falls immediately on German-based investors in the United States or on United States investors in Germany.

5. Treaty implications

In a bilateral context, a unitary approach which stops at water's edge and which limits the aggregate of apportioned tax bases to the total domestic tax base cannot be reason for concern. It constitutes a mere proxy for revenue sharing between various national and sub-national jurisdictions. This understanding is reflected in the U.S. – German Tax Treaty to the extent that it grants protection for German Trade Tax, a tax based on a unitary approach limited to domestic income apportionment. The foundation for the present understanding, however, is upset where unitary schemes are implemented across national frontiers. The German enterprises, faced with the incidence of such practices, have every right to be concerned and to solicit protection against such imbalances. In the absense of internal legislation by the United States Congress, the only means to provide protection would appear to be the Tax Treaty itself. The Federal Government therefore feels that the problem of establishing a balanced treaty framework which appropriately addresses the unitary issue needs to be considered. The Federal Government cannot totally exclude that the different treatment of the German Trade Tax and unitary State taxes under the present treaty will prove to be counterproductive to a speedy conclusion of the ongoing Treaty renegotiations if the international implications of unitary State taxes continue to exist in the future.

APPENDIX II

GERMANY: RULES ON COST SHARING CONTRACTS

(Reproduced from *Intertax* 1983/5 pp. 165 ff.)

On 23 February 1983 the German tax authorities published the final guidelines on intercompany pricing, which have the legal qualification of regulations.[1] *Complete English and French translations of these guidelines will soon be published by Kluwer.*[2] *Subsequently part 7 of these guidelines is reproduced, which deals with cost sharing arrangements in international groups. This is the first time that the German tax authorities published an opinion on this widely discussed subject.*

7. Income Allocation by Means of Cost Sharing Contracts

7.1. General

7.1.1. If expenses for
a. research and development or
b. administrative services (para. 6.2.2.)
are charged off within a group of related enterprises by means of cost sharing then the cost sharing contract is to be taken as the starting point for the income allocation if the consideration for the transfers or services thus charged off can only be valued in aggregate, or if the determination of the costs separately attributable to the individual services presents difficulty. These cost sharing contracts are to be examined in accordance with the following principles (see also para. 2.4.3.).

7.1.2. The costs actually incurred in rendering such intra group services are (as in the case of a pool) to be determined by means of a recognized costing method on a full-cost basis (direct and indirect costs) and are to be distributed according to a recognized method of accounting. It is required that the cost sharing contract (para. 7.2.) be concluded in advance in clear and unambiguous terms and that it be actually carried out. A sharing arrangement based on a percentage – determined without reference to costs – of the turnover of the taxpayer enterprise, or of a similar reference to costs – of the turnover of the taxpayer enterprise, or of a similar reference base, cannot be recognized for tax purposes.

7.1.3. Upon implementation of the cost sharing contract no separate charges can be made for the transfer of the right to use intangible property, for the transfer of know-how and for services to which the taxpayer enterprise has a right (para. 7.2.1. No. 2.). In accordance with § 5 (2) EStG, these items of property cannot be treated as assets in the balance sheet; the costs shared are not subject to withholding tax within § 50a (4) EStG.

7.1.4. If the sharing arrangement is to be recognized for tax purposes then the research and development, and the flow of administrative services (para. 6.2.) must be clearly distinguishable and supported by evidence. The aggregate of costs attributable to them must be easily separable. These requirements are in general met if:
1. there is within the group a central organization responsible for providing such services, the benefit of the services being derived either by the group as a whole or by particular sub-groups of corporations, and
2. the costs which arise in other parts of the group from complementary or supporting activities of the same kind (affiliated departments) are aggregated within this central organization.

7.1.5. A cost sharing contract can only be recognized for tax purposes if the requirements of para. 1.4. are met and if also the enterprise which charges off the costs incorporates the terms of the contract in its business accounts and computations of tax liability. The cost sharing contract must also be taken into account in the commercial balance sheet to the extent that the same has a binding effect for the tax balance sheet.

7.1.6. A profit mark-up on shared costs cannot be recognized for tax purposes in view of the absence of entrepreneurial risk. This does not rule out that, within the framework of the full-cost computation, an appropriate amount for interest on the capital invested as well as a contribution to executive and general administrative expenses are included in the costs to be shared.

7.2. The Terms of the Contract

7.2.1. A cost sharing contract will serve as the basis for income allocation if:
1. the contract takes into account research and development costs which relate or will relate to the commercial activity of the taxpayer enterprise, as well as the costs of adminis-

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1. Bundessteuerblatt 1983 Teil I S. 218.
2. Orders may be directed to Kluwer Law and Taxation Publishers, P.O. Box 23, 7400 GA Deventer, the Netherlands.

trative services, which are actually provided in the interest of the taxpayer enterprise; and if the taxpayer enterprise actually uses, or can be expected to use, the results of the research and development and of the administrative services;
2. the contract establishes on the part of the taxpayer enterprise a specific right, definite both in nature and scope, to benefit from the activities of the central organization and the affiliated departments in exercising the functions assigned to it, and the right to request services from the central organization or to give it instructions;
3. the contract bases the sharing arrangement on the costs (including indirect costs) which
   a. are attributable to the activities of the central organization and the affiliated departments and
   b. actually arose in the accounting year.
   The costs must be clearly distinguishable by reference to the contract. Applying the criteria of requirements 1 and 4, costs of basic research may also be the subject of a sharing arrangement;
4. the contract includes agreed apportionment formula corresponding to the extent to which the taxpayer enterprise actually benefits, or can be expected to benefit, from the results of the research and development carried out and from the administrative services provided within the group. The appropriate share of the benefits is to be ascertained by applying business principles and using the degree of care shown by a sound business manager. The ratio given by the respective turnovers of the group members can only be applied as a basis if this is a useful standard for determining the actual or expected benefits for the related enterprises involved;
5. the contract provides that the costs are to be reduced by the amount of any profits which were received by the central organization or the affiliated departments and which result from activities or assets falling within the scope of the cost sharing contract;
6. the contract provides that the costs borne by the taxpayer enterprise itself in connection with functions falling within the scope of the cost sharing contract, be taken into account following the same principles as apply to the central organization, be included in the costs to be shared, and be credited against the shared portion.

7.2.2. No set off of benefits can be made between the individual items in a cost sharing contract and other services falling outside the scope of the cost sharing process.

7.2.3. If expenses for research and development and for administrative services are covered together in a single cost sharing contract then the expenditure to be shared and the cost apportionment formulae for each type of transfer must be verifiable separately.

7.2.4. The tax office may, on application of the taxpayer, accept other arrangements for individual cases if this is appropriate given special circumstances (such as the multilateral employment of the sharing arrangement, or in the absence of individual provisions regarding the cost computation and distribution as prescribed by para. 7.2.1.) and provided that the domestic results of the sharing arangement do not differ significantly from those of a contract which conforms to the rules contained in paras. 7.1. to 7.2.3.

7.3. The Implementation of the Contract

7.3.1. A cost sharing contract can be accepted for tax purposes if, in the event of changes, the enterprise adapts it to any new situation. In particular the cost apportionment formulae must be adapted if there is any alteration in the division of responsibilities within the group on which the contract was based.

7.3.2. If a group charges off costs by using cost sharing contracts then the costs shared in this way may not be passed on a second time, e.g. by inclusion in transfer prices for goods or services.

7.4. Evidence

7.4.1. If the allocation of income is to be based on a cost sharing contract then the taxpayer enterprise upon request must
1. produce the contract together with all related agreements and by means of verifiable documents prove the benefits which the taxpayer enterprise derives from research and development, and the flow of administrative services;
2. specify the division of responsibilities within the group on which the contract is based, and the functions performed by the group unit involved. It must furthermore produce verifiable documents regarding the criteria which have been relevant for establishing and applying in every instance the cost apportionment formula;
3. produce all directions given for the inclusion, delimitation and apportionment of costs, the bookkeeping instructions given, and the computation of the amounts to be shared (in particular detailed specifications of the kinds of costs – classified according to cost centres – which are covered by the cost sharing arrangement).

Production of documents for the cost sharing computation which are exclusively located abroad can be waived to the extent that the taxpayer enterprise submits a cost sharing computation which shows that both the underlying obligation for and the amounts of the costs shared were arrived at in accordance with the terms of the sharing arrangement, and which has been audited and bears a notice of confirmation to these effects by a German chartered accountant or tax consultant or by a German accounting or tax consulting firm.

7.4.2. As provided in § 90 (2) AO the tax authority can require further data, documents and evidence necessary according to the circumstances of the individual case. This applies in particular
a. if it cannot be expected that the tax authorities in the country of the parent corporation will upon request render administrative assistance in an examination of the cost apportionment system and its annual results;
b. for the purpose of providing evidence that the requirements contained in para. 7.1.4. 1st and 2nd sentences are met in cases where an organizational group structure such as described in para. 7.1.4. 3rd sentence is lacking; or
c. if individual requirements within the preceding paras. are not met, or particular evidence cannot be produced, and if these shortcomings are compensated by additional requested evidence.

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UNITED STATES: UNITARY TAXATION

A dissenting opinion

In the February 1984 issue of the *Bulletin* we published the decison of the U.S. Supreme Court in *Container Corporation of America (Appellant) v. Franchise Tax Board* of 27 June 1983. The Court ruled for the Franchise Tax Board, thus permitting the application of unitary taxation in California. However, Justice Powell, with whom the Chief Justice and Justice O'Connor joined, dissented. The views of Justice Powell are reproduced below.

The Court's opinion addresses the several questions presented in this case with commendable thoroughness. In my view, however, the California tax clearly violates the Foreign Commerce Clause – just as did the tax in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979). I therefore do not consider whether appellant and its foreign subsidiaries constitute a "unitary business" or whether the State's apportionment formula is fair.

With respect to the Foreign Commerce Clause issue, the Court candidly concedes: (i) "double taxation is a constitutionally disfavored state of affairs, particularly in the international context", [. . .] (ii) "like the tax imposed in *Japan Line,* [California's tax] has resulted in actual double taxation," [. . .] and therefore (iii) this tax "deserves to receive close scrutiny." [. . .] The Court also concedes that "[t]his case is similar to *Japan Line* in a number of important respects," [. . .] and that the Federal Government "seems to prefer the [arm's-length] taxing method adopted by the international community." [. . .] The Court identifies several distinctions between this case and *Japan Line,* however, and sustains the validity of the California tax despite the inevitable double taxation and the incompatability with the method of taxation accepted by the international community.

In reaching its result, the Court fails to apply "close scrutiny" in a manner that meets the requirements of that exacting standard of review. Although the facts of *Japan Line* differ in some respects, they are identical on the critical questions of double taxation and federal uniformity. The principles enunciated in that case should be controlling here: a state tax is unconstitutional if it either "creates a substantial risk of international multiple taxation" or "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" 441 U.S., at 451.

I

It is undisputed that the California tax not only "creates a substantial risk of international multiple taxation," but also "has resulted in actual double taxation" in this case. [. . .] As the Court explains, this double taxation occurs because California has adopted a taxing system that "serious[ly] diverge[s]" from the internationally accepted taxing methods adopted by foreign taxing authorities. [. . .] The Court nevertheless upholds the tax on the ground that California would not necessarily reduce double taxation by conforming to the accepted international practice.[1] [. . .] This argument fails to recognize the fundamental difference between the current double taxation and the risk that would remain under an arm's-length system. I conclude that the California tax violates the first principle enunciated in *Japan Line*.

At present, double taxation exists because California uses an allocation method that is different in its basic assumptions from the method used by all of the countries in which appellant's subsidiaries operate. The State's formula has no necessary relationship to the amount of income earned in a given jurisdiction as calculated under the arm's-length method. On the contrary, the formula allocates a higher proportion of income to jurisdictions where wage rates, property values, and sales prices are higher. See J. Hellerstein & W. Hellerstein, State and Local Taxation 538-539 (4th ed, 1978). To the extent that California is such a jurisdiction, the formula inherently leads to double taxation.

Appellant's case is a good illustration of the problem. The overwhelming majority of its overseas income is earned by its Latin American subsidiaries. See app. 112. Since wage rates, property values, and sales prices are much lower in Latin America than they are in California, the State's apportionment formula systematically allocates a much lower proportion of this income to Latin America than does the internationally accepted arm's-length method.[2] Correspondingly, the formula allocates a higher proportion of the income to California, where it is subject to state tax. As long as the three factors remain higher in California, it is inevitable that the State will tax income under its formula that already has been taxed by another country under accepted international practice.

In the tax years in question, for example, over 27% of appellant's worldwide income was earned in Latin America and taxed by Latin American countries under the arm's-length method. [. . .] Latin American wages, however, represented under 6% of the worldwide total; Latin American property was about 20% of the worldwide total; and Latin American sales were less than 14% of the worldwide total. [. . .] As a result, roughly 13% of appellant's worldwide income – less than half of the arm's-length total – was allocated to Latin America under California's formula. In other words, over half of the income of appellant's largest group of subsidiaries was allocated elsewhere under the State's formula. In accord-

1. The Court also appears to attach some weight to its view that California is unable "simply [to] adher[e] to one bright-line rule" to eliminate double taxation. [. . .] From California's perspective, however, a bright-line rule that avoids Foreign Commerce Clause problems clearly exists. The State simply could base its apportionment calculations on appellant's United States income as reported on its federal return. This sum is calculated by the arm's-length method, and is thus consistent with international practice and federal policy. Double taxation is avoided to the extent possible by international negotiation conducted by the Federal Government. California need not concern itself with the details of the international allocation, but could apportion the American income using its three-factor formula.

2. Although there are a few foreign countries where wage rates, property values, and sales prices are higher than they are in California, appellant's principal subsidiaries did not operate in such countries.

ance with international practice, all of this income had been taxed in Latin America, but the California system would allow the income to be taxed a second time in California and other jurisdictions. This problem of double taxation cannot be eliminated without either California or the international community changing its basic tax practices.

If California adopted the arm's-length method, double taxation could still exist through differences in application.[3] California and Columbia, for example, might apply different accounting principles to a given intracorporate transfer. But these types of differences, although presently tolerated under international practice, are not inherent in the arm's-length system. Moreover, there is no reason to suppose that they will consistently favor one jurisdiction over another. And as international practice becomes more refined, such differences are more likely to be resolved and double taxation eliminated.

In sum, the risk of double taxation can arise in two ways. Under the present system, it arises because California has rejected accepted international practice in favor of a tax structure that is fundamentally different in its basic assumptions. Under a uniform system, double taxation also could arise because different jurisdictions – despite their agreement on basic principles – may differ in their application of the system. But these two risks are fundamentally different. Under the former, double taxation is inevitable. It cannot be avoided without changing the system itself. Under the latter, any double taxation that exists is the result of disagreements in application. Such disagreements may be unavoidable in view of the need to make individual judgments, but problems of this kind are more likely to be resolved by international negotiation.

On its face, the present double taxation violates the Foreign Commerce Clause. I would not reject, as the Court does, the solution to this constitutional violation simply because an international system based on the principle of uniformity would not necessarily be uniform in all of the details of its operation.

II

The Court acknowledges that its decision is contrary to the Federal Government's "prefer[ence for] the taxing method adopted by the international community." [. . .] It also states the appropriate standard for assessing the State's rejection of this preference: "a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive. [. . .] The Court concludes, however, that the California tax does not prevent the Federal Government from speaking with one voice because it perceives relevant factual distinctions between this case and *Japan Line.* I conclude that the California taxing plan violates the second principle enunciated in *Japan Line,* despite these factual distinctions, because it seriously "implicates foreign policy issues which must be left to the Federal Government."

The Court first contends that "the tax here does not create an *automatic* 'asymmetry.' " [. . .] This seems to mean only that the California tax does not result in double taxation in every case. But the fundamental inconsistency between the two methods of apportionment means that double taxation is inevitable. Since California is a jurisdiction where wage rates, property values, and sales prices are relatively high, double taxation is the logical expectation in a large proportion of the cases. Moreover, we recognized in *Japan Line* that "[e]ven a slight overlapping of tax – a problem that might be deemed de minimis in a domestic context – assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." 441 U.S., at 456.

The Court also relies on the fact that the taxpayer here technically is a domestic corporation. [. . .] I have several problems with this argument. Although appellant may be the taxpayer in a technical sense, it is unquestionable that California is taxing the income of the foreign subsidiaries. Even if foreign governments are indifferent about the overall tax burden of an American corporation, they have legitimate grounds to complain when a heavier tax is calculated on the basis of the income of corporations domiciled in their countries. If nothing else, such a tax has the effect of discouraging American investment in their countries.

The Court's argument is even more difficult to accept when one considers the dilemma it creates for cases involving foreign corporations. If California attempts to tax the American subsidiary of an overseas company on the basis of the parent's worldwide income, with the result that double taxation occurs, I see no acceptable solution to the problem created. Most of the Court's analysis is inapplicable to such a case. There can be little doubt that the parent's government would be offended by the State's action and that international disputes, or even retaliation against American corporations, might be expected.[4] It thus seems inevitable that the tax would have to be found unconstitutional – at least to the extent it is applied to foreign companies. But in my view, invalidating the tax only to this limited extent also would be unacceptable. It would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation. I would not permit such discrimination[5] without explicit congressional authorization.

The Court further suggests that California could impose the same tax burden on appellant under the arm's-length

3. Similarly, there could be double taxation if the entire international community adopted California's method of formula apportionment. Different jurisdictions might apply different accounting principles to determine wages, property values, and sales. Indeed, any system that calls for the exercise of any judgment leaves the possibility for some double taxation.

4. This is well illustrated by the protests that the Federal Government already has received from our principal trading partners. Several of these are reprinted or discussed in the papers now before the Court. See, e.g., App. to Brief for the Committee on Unitary Tax as *Amicus Curiae* 7 (Canada); id., at 9 (France); id., at 13-16 (United Kingdom); id., at 17-19 (European Economic Community); App. to Brief for the International Bankers Association In California as *Amicus Curiae* in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.,* O.T. 1981, No. 81-349, pp, 4-5 (Japan); Memorandum for the United States as *Amicus Curiae* in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.,* O.T. 1981, No. 81-349, p. 3 ("[A] number of foreign governments have complained – both officially and unofficially – that the apportioned combined method . . . creates an irritant in their commercial relations with the United States. Retaliatory taxation may ensue . . ."); App. to id., at 2a-3a (United Kingdom); id., at 8a-9a (Canada).

5. California is, of course, free to tax its own corporations more heavily than it taxes out-of-state corporations.

system simply by raising the general tax rate. [. . .] Although this may be true in theory, the argument ignores the political restraints that make such a course infeasible. If appellant's tax rate were increased, the State would be forced to raise the rate for all corporations.[6] If California wishes to follow this course, I see no constitutional objection. But it must be accomplished through the political process in which corporations doing business in California are free to voice their objections.

Finally, the Court attaches some weight to the fact that "the Executive Branch has decided not to file an *amicus curiae* brief in opposition to the state tax." [. . .] The Court, in a footnote, dismisses the Solicitor General's memorandum in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.,* No. 81-349, despite the fact that it is directly on point and the case is currently pending before the Court. [. . .] In this memorandum, the Solicitor General makes it clear beyond question what the Executive Branch believes: "imposition of [a state tax] on the apportioned combined worldwide business income of a unitary group of related corporations, including foreign corporations, impairs federal uniformity in an area where such uniformity is essential."[7] Memorandum for the United States as *Amicus Curiae* in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.,* O.T. 1981, No. 81-349, p. 2. I recognize that the Government may change its position from time to time, but I see no reason to ignore its view in one case currently pending before the Court when considering another case that raises exactly the same issue. The Solicitor General has not withdrawn his memorandum, nor has he supplemented it with anything taking a contrary position. As long as *Chicago Bridge & Iron* remains before us, we must conclude that the Government's views are accurately reflected in the Solicitor General's memorandum in that pending case.

In sum, none of the distinctions on which the Court relies is convincing. California imposes a tax that is flatly inconsistent with federal policy. It prevents the Federal Government from speaking with one voice in a field that should be left to the Federal Government.[8] This is an intrusion on national policy in foreign affairs that is not permitted by the Constitution.

III

In *Japan Line* we identified two constraints that a state tax on an international business must satisfy to comply with the Foreign Commerce Clause. We explicitly declared that "[i]f a state tax contravenes either of these precepts, it is unconstitutional." 441 U.S., at 451. In my view, the California tax before us today violates *both* requirements. I would declare it unconstitutional.

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6. The State could not raise the tax rate for appellant alone, or even for corporations engaged in foreign commerce, without facing constitutional challenges under the Equal Protection or the Commerce Clause.
7. *Chicago Bridge & Iron,* it might be noted, is a case in which the state tax is imposed on an American parent corporation.
8. The Court relies on the absence of a "clear federal directive." [. . .] In light of the Government's position, as stated in the Solicitor General's memorandum, [. . .] the absence of a more formal statement of its view is entitled to little weight.

The European Parliament Versus Unitary Taxation

On 12 December 1984 the European Parliament adopted the following resolution:[1]

RESOLUTION
on taxation of companies by American States

The European Parliament,

A. Noting that a number of American States have adopted a world-wide system of taxing companies on an imputed percentage of their profits known as unitary tax, effectively taxing profits earned outside the USA,

B. Aware that the US Supreme Court has accepted the legality of such a system for domestic US corporations,

C. Concerned that this decision may be taken to extend to American companies with subsidiaries in Europe and the American subsidiaries of Community based companies,

1. Considers that the principle of unitary tax is contrary to the spirit of the various double taxation treaties and discriminates unfairly against European-based companies with operations in the United States;

2. Regrets that the United States Administration did not file an *amicus curiae* brief in the Supreme Court case of Container Corporation of the US v. California Trustees which would have enabled the position of overseas companies to be clarified;

3. Urges the Administration to give full-hearted support to legislation before the Congress which would exempt overseas companies from this discriminatory form of tax;

4. Urges the Commission to instruct its Delegation in Washington to continue to press this matter which can only damage relations between the Community and the United States to the detriment of their mutual economic and political interests;

5. Believes that failure by the Administration and Congress to act in this way would justify the suspension of the double taxation treaties by the Member States;

6. Instructs its President to forward this resolution to the President of the Commission, the Head of the US Mission to the European Communities and the Chairman of the Delegation of the US Congress to the European Parliament.

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1. Official Journal of the European Communities No. C 10 of 16 January 1984 at 1.

GUATEMALA:
An Overview of the 1983 Tax Reform

by M.A. García Caballero

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I. INTRODUCTION

A thorough reform of the Guatemalan tax system was undertaken through a series of Decree-Laws of 6 July 1983. This reform, which became effective on 1 August 1983, focussed principally on income tax (Decree-Law 73/83) and on sales tax (Decree-Law 72/83).[1]

The new government which took power on 8 August 1983, amended Decree-Laws 73/83 and 72/83 by Decree-Law 120/83 of 23 September 1983 and continued the tax reform by repealing the existing legislation on hydrocarbons and providing a more attractive Hydrocarbon Law in Decree-Law 109/83 of 15 September 1983.

The discussion below deals with the most important aspects of the 1983 tax reform, as it stands after the newly introduced amendments and legislation, first as regards the new system of taxation of Guatemalan-source income derived by resident and non-resident individuals and companies and as regards export incentives; then as regards the value added tax; and finally as regards the new legislation on exploration, exploitation, development, production, processing, transportation and sale of hydrocarbons and oil products.

II. THE NEW INCOME TAX AND EXPORT INCENTIVE SYSTEM

Decree-Law 73/83 of 6 July 1983 has two parts that deal respectively with amendments and additions to the Income Tax Law (implemented by Government Agreement 570/83 of 27 July 1983), as amended by Decree-Law 120/83 of 23 September 1983, and with export incentives.

The new income tax system

The reform, as amended, has introduced a fairer and more modern system of income tax, encouraging domestic productivity and direct foreign investment.[2] Under the former system, resident individuals and companies were subject to the same progressive income tax rate table; now, while individuals remain subject to the former progressive rates, companies (including branches and agencies of foreign enterprises) are subject to special company income tax rates. Moreover, the former surcharges, which were imposed at the rates of 10% (on the tax due for the first 10,000 quetzals (1Q = US$1) as well as on remittances abroad) and of 21% (on the excess over 10,000 Q), have been abolished. On the other hand, dividends and income distributed, which under the former system were not subject to tax, are now subject to tax under an imputation system, unless the paying company is expressly exempt from tax. It has been further established that for interest on foreign loans to be exempt from tax, the foreign currency received on such loans must be sold directly to a domestic banking institution and that for interest and financial expenses on loans to be exempt from tax, the loans must be used to produce income or to maintain existing sources of income production.

1. Income tax table for resident individuals

The annual tax due is assessed in accordance with the progressive rates[3] indicated in Table I.

2. Withholding tax system

a. *Residents*

– *General rates on earned income*

Income earned from dependent work (i.e. employment) is subject to a progressive withholding tax at rates to be established by the Directorate General for Internal Revenue.

– *Tax on dividends and profits distributed*

Dividends and income deemed to be dividend paid out of profits imputable to periods ending on or before 31 July 1983 are not subject to tax. However, dividends and income deemed to be dividend paid out of profits imputable to periods commencing after 31 July 1983 are subject to withholding tax at the rate of 10% on account of the final income tax due, unless the paying company is exempt.[4]

1. Other indirect taxes amended relate to the tax on consumption of alcoholic beverages (Decree-Law 74/83), which has been transformed into an ad valorem tax; to the tax on consumption of cigarettes (Decree-Law 75/83); to the passenger's exit tax (Decree-Law 76/83); to the tax on establishments that sell spirits and alcoholic drinks (Decree-Law 77/83); and to the elimination of a series of small taxes (Decree-Law 78/83).

2. I.e. encouraging foreign participation in Guatemalan companies and creation of branches and agencies of foreign companies.

3. Resident shareholders and partners must include in their annual declaration of income tax the following gross income items, when applicable:
- gross dividend and profit distributed plus the appropriate tax credit and amounts withheld thereupon on account of income tax;
- any other item of income;

then, they must subtract from the total gross income the necessary expenses incurred to produce the income;
then, they must subtract the authorized personal and family allowances (i.e. 1,200 Q exempt minimum; 2,200 Q for taxpayers with dependents; 1,400 Q for spouses with an annual income not exceeding 1,400 Q and 1,200 Q for each close family relative with income not exceeding 1,200 Q p.a.) and the other personal expenses incurred (i.e. social security premiums; life, illness and accident insurance premiums paid by the taxpayer for himself, spouse and minor children; 20% of the net income with a limit of 2,000 Q; 100% of the fees paid for professional services rendered by university graduates authorized to practice in the country and any losses incurred in previous years;
then, the appropriate income tax rate is applied on the taxable income and the tax liability is established;

Table I

Taxable income (Q)	Tax due on lower limit (Q)	Tax rate on excess over lower limit (%)
1– 1,000	–	5.00
1,000– 1,500	50.00	5.25
1,500– 2,000	76.25	5.50
2,000– 2,500	103.75	5.75
2,500– 3,000	132.50	6.00
3,000– 3,500	162.50	6.25
3,500– 4,000	193.75	6.50
4,000– 4,500	226.25	6.75
4,500– 5,000	260.00	7.00
5,000– 5,500	295.00	7.25
5,500– 6,000	331.25	7.50
6,000– 6,500	368.75	7.75
6,500– 7,000	407.50	8.00
7,000– 7,500	477.50	8.25
7,500– 8,000	488.75	8.50
8,000– 8,500	531.25	8.75
8,500– 9,000	575.00	9.00
9,000– 9,500	620.00	9.25
9,500– 10,000	666.25	9.50
10,000– 10,500	713.75	9.75
10,500– 11,000	762.50	10.00
11,000– 11,500	812.50	10.25
11,500– 12,000	863.75	10.50
12,000– 12,500	916.25	10.75
12,500– 13,000	970.00	11.00
13,000– 13,500	1,025.00	11.25
13,500– 14,000	1,081.25	11.50
14,000– 14,500	1,138.75	11.75
14,500– 15,000	1,197.50	12.00
15,000– 16,000	1,257.50	12.50
16,000– 17,000	1,382.50	13.00
17,000– 18,000	1,512.50	13.50
18,000– 19,000	1,647.50	14.00
19,000– 20,000	1,787.50	14.50
20,000– 21,000	1,932.50	15.00
21,000– 22,000	2,082.50	15.50
22,000– 23,000	2,237.50	16.00
23,000– 24,000	2,397.50	16.50
24,000– 25,000	2,562.50	17.00
25,000– 26,000	2,732.50	17.50
26,000– 27,000	2,907.50	18.00
27,000– 28,000	3,087.50	18.50
28,000– 29,000	3,272.50	19.00
29,000– 30,000	3,462.50	19.50
30,000– 32,000	3,657.50	20.00
32,000– 34,000	4,057.50	20.50
34,000– 36,000	4,467.50	21.00
36,000– 38,000	4,887.50	21.50
38,000– 40,000	5,317.50	22.00
40,000– 42,000	5,757.50	22.50
42,000– 44,000	6,207.50	23.00
44,000– 46,000	6,667.50	23.50
46,000– 48,000	7,137.50	24.00
48,000– 50,000	7,617.50	24.50
50,000– 60,000	8,107.50	25.75
60,000– 70,000	10,682.50	27.00
70,000– 80,000	13,382.50	28.25
80,000– 90,000	18,207.50	29.50
90,000–100,000	19,157.50	30.75
100,000–125,000	22,232.50	32.25
125,000–150,000	30,295.00	33.75
150,000–175,000	38,732.50	35.25
175,000–200,000	47,545.00	36.75
200,000–250,000	56,732.50	38.75
250,000–300,000	76,107.50	40.75
300,000–400,000	96,482.50	43.00
400,000–500,000	139,482.50	45.50
500,000 and over	184,982.50	48.00

– *Tax on interest and royalties*

These are not subject to withholding tax.

– *Tax on fees, allowances, commissions, bonuses and similar payments*

Remuneration paid as consideration for services rendered by individual and corporate taxpayers (except by independent artists and craftsmen) is subject to withholding tax at the rate of 5% on account of the final income tax due.

b. *Non-residents*

– *Tax on dividends and profits distributed*

Dividends and income deemed to be dividend paid out of profits imputable to periods ending on or before 31 July 1983, whether or not the company is exempt, are subject to withholding tax at the rate of 12.1% and, where paid out of profits imputable to periods commencing after 31 July 1983, at the rate of 12.5%, which is in both cases the final tax.

– *Tax on interest*

Although interest is in principle not subject to tax, interest and related financial costs on foreign loans are subject to withholding tax at the rate of 10% (which is a final tax) in those cases where the foreign currency received on the loan was not sold to a domestic banking institution.

– *Tax on royalties and payments for technical assistance*

These payments are subject to a withholding tax at the rate of 25% which is a final tax; the 25% rate applies as well to any other type of Guatemalan-source income that is not specifically subject to another withholding tax rate.[5]

– *Tax on fees, allowances, commissions, bonuses and similar payments*

Remuneration paid as consideration for services rendered by non-resident individual and corporate taxpayers is subject to withholding tax at the rate of 20% which is final;

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finally, the amount of taxes withheld and the appropriate tax credit on dividends/profits received is offset against the income tax liability. Where the income tax liability is less than the credit to which the taxpayer is entitled, the tax administration will use the excess to offset other tax liabilities of the taxpayer and the remainder, if any, will be refunded.

4. The normal financial and tax period begins on 1 July of a calendar year and ends on 30 June of the following year.

5. In accordance with Art. 31 of the Regulation to the Income Tax Amendment Law (i.e. Government Agreement 570/83 of 27 July 1983), the final 25% withholding tax on "any other type of Guatemalan-source income" applies to income derived from:

- real property situated in Guatemala, agriculture, cattle raising, forestry, fishing, mining and exploitation of other natural resources and other income from real property;
- capital, property or rights located or used for business purposes in the country;
- the lease of movable property used in the country;
- life annuities and similar income originating in the country;
- civil, commercial, industrial and similar activities and the exercise of a profession or an office and any type of service rendered in the country;
- personal, professional and technical services rendered in and outside of Guatemala to resident individuals and companies and those rendered in Guatemala to non-resident individuals and companies;
- any other type of income not described above which is generated from tangible or intangible property situated, used or placed in the country or which arises from activities of any kind performed in the country, as well as personal work performed outside of Guatemala by residents on a temporary basis.

– *Tax on insurance and reinsurance premiums and guarantee payments*

Where these types of payments are effected before the end of the tax period, they are subject to withholding tax at the rate of 1% on account of the final income tax.

3. Taxation of special business activities of non-residents

Non-resident companies without a branch or agency in Guatemala deriving Guatemalan-source income from transportation, motion picture films or other temporary entertainment and from reinsurance and the establishment of collateral guarantees are subject to the following system of income tax:

(i) *Transportation enterprises*

The tax is imposed at the rate of 20% on 10% of the gross income from freight and passenger tickets originating in Guatemala (thus the tax is imposed at an effective rate of 2% on gross income).

(ii) *Motion picture film enterprises*

Non-resident film producers and distributors are subject to tax at the rate of 20% on 80% of the gross income invoiced, less the commission paid to the resident agent. Resident impresarios, promoters or contractors of other public show business enterprises must apply a 10% withholding tax to the gross income which is a final tax.

(iii) *Reinsurance and collateral guarantee enterprises*

Ten percent of the gross amount of insurance and reinsurance premiums and of the amounts paid as consideration of collateral guarantees is subject to income tax at the rates established for resident companies (i.e. from 5% to 42%).

4. Taxation of resident companies

a. *Special deductions*

Resident companies, including branches and agencies of non-resident enterprises, may deduct as expenses, if applicable, these maximum percentages:

- on royalties: with the prior authorization of the Ministry of Economy, 15% of the gross income from sales within the taxable period concerned relating to the royalty costs incurred;
- on technological research: with the joint approval of the Ministries of Economy and of Labor and Social Affairs, 20% of the paid-up capital plus reserves at the beginning of the financial period (i.e. on 1 July of any calendar year) in the case of companies, or of the capital allocated to the enterprise benefiting from the research, in the case of individual entrepreneurs, and in both instances relating to the technological research costs incurred;
- on technical assistance: with the prior approval of the Ministry of Labor and Social Affairs, 1% of the gross income derived in the taxable period concerned, relating to technical assistance costs incurred, including fees paid to non-resident parents and head offices for managerial and technical services;
- on remuneration paid by foreign head offices: the amount of salaries and wages paid from abroad to officers and employees of the branch or agency and refunded to the head offices may also be deducted from the gross income of the branch or agency. However, no other remuneration paid by the branch or agency to the foreign head office for participation in the administration or supervisory costs incurred by head offices may be deducted from the gross income of the branch or agency.

b. *Income tax assessment*

Resident companies, including branches and agencies of foreign enterprises, whose tax period ended after 31 July 1983 are required to file two separate income tax returns, as follows:

(i) one pertaining to income derived between the first day of their tax period and 31 July 1983; the tax assessment is to be effected in accordance with the income tax legislation prior to the income tax reform (i.e. applying the progressive income tax table, as well as the former surcharges);

(ii) the second pertains to income derived between 1 August 1983 and the last day of their tax period; this tax assessment is to be effected in accordance with the income tax reform, as amended by Decree-Law 120/83 (see for tax rates Table II).

Table II

Taxable income (in Q)	Tax on lower limit (in Q)	Tax rate on excess over the lower limit (in %)
1 - 5,000		5
5,000 - 23,000	250	11.3
23,000 - 80,000	2,284	24
80,000 - 2,000,000	15,964	30
2,000,000 onward	591,964	42

The available or distributable income of resident branches and agencies of foreign companies is further subject to a final withholding tax which is imposed at the rates of 12.1% or 12.5% depending on whether the income (out of which profits are paid or credited in cash or in kind to the head offices) was imputable to periods ending on or before 31 July 1983 or after this date, respectively. Distributable income – which is deemed to be a dividend for income tax purposes – includes the positive balance of the profit and loss account when paid or booked in favor of the head offices, and it is determined by subtracting from the taxable profits the company income tax due in accordance with the above rates.

5. Unilateral measure to avoid internal double taxation of dividends and profit distributed

Resident shareholders or partners who receive dividends or profit from participations or rights in the capital of resident companies (including branches and agencies of foreign enterprises), provided that the paying company is not exempt, benefit from a tax credit whose amount is calculated by multiplying their share or participation percentage in the company's capital by the company income tax liability and multiplying further the resulting sum by the ratio existing between the total profits and the dividend or profit distributed.[6]

Table III illustrates the manner in which the tax credit is calculated.

Table III

Company's equity capital (in Q)	Share-holder's equity (in %)	Total net profits (in Q)	Distributed dividend (in Q)	Ratio dividend/ total profits	Company tax liability (in Q)	Share-holder tax credit
1,000,000	25	200,000	120,000	60	51,964	7,794.6

I.e. 0.25 x 51,964 x 0.60. Note that the shareholder, in calculating his taxable income, must declare the gross dividend received, as increased by the apportioned tax credit and by the tax withheld at the rate of 10%.

6. Export incentives

In order to reactivate the domestic economy, a gradual elimination of the current duties on exports (levied at rates varying from 5% to 45% of the f.o.b. prices) has been undertaken; at the same time, tax incentives have been introduced in order to encourage exportation of non-traditional products.

The gradual elimination of export duties is established as follows:

(i) the former duty on exportation of cattle, levied at 40 Q a head, has been eliminated;
(ii) a 50% reduction applies to exports made until 30 June 1984;
(iii) a 75% reduction applies to exports made during the period 1 July 1984 – 30 June 1985;
(iv) total elimination of the customs duties on exports made as of 1 July 1985; accordingly, exports of agricultural products and cattle, including coffee, cotton, sugar, banana, beef, lamb, pork, poultry, fish and essential oils (which are all traditional products) will be duty-free as from 1 July 1985.

The tax incentives to exportation of non-traditional products[7] as of 1 November 1983 are as follows:

(i) a tax credit certificate (CAT – certificado de abono tributario) equal to 10% of the f.o.b. prices of such products is granted by the Ministry of Finance. CATs are exempt from tax, have one-year maturity, are transferable by simple endorsement and may be used to pay any other tax liability, including import duties. However, exportation of non-traditional products to countries with which Guatemala has signed a free trade agreement (bilateral or multilateral) is not eligible for CATs;
(ii) CATs are increased to 15% where "new" non-traditional products[8] are exported to countries with which Guatemala does not have a free trade agreement (bilateral or multilateral), or where such new products are not included in the existing free trade agreements.

6. The amount of this credit is established as follows: first, the ratio that the shareholder/partner's portion of capital bears to the equity capital of the company is to be established; this percentage is then multiplied by the company income tax liability; the resulting sum is then multiplied by the ratio that the amount of the dividend or profit distributed bears to the total amount of annual net profits (i.e. including undistributed profits). The resulting amount is the appropriate tax credit.
7. The Ministry of Finance will establish which are these products.
8. These products are to be listed by the Ministry of Finance.
9. Guatemala did not have an independent sales tax as such; sales, imports and services were taxed by means of a stamp tax at the rate of 3% paid by the consumers on a cascade basis.
10. "Non-personal services" are those services rendered by resident individual and corporate enterprises (including public entities) to resident and non-resident users and those rendered in Guatemala by non-resident individual and corporate enterprises, as well as those rendered by enterprises where a professional, in an independent or dependent relationship, invoices on behalf of an enterprise or in his own name, but the remuneration is collected by the enterprise itself. "Non-personal services" include also those services rendered by individual entrepreneurs with at least 3 dependent employees and by professionals with at least 3 other professionals as dependent employees.

III. THE NEW VALUE ADDED TAX

The VAT Law (ley de impuesto sobre el valor agregado en la venta de mercancías y en la prestación de servicios no personales) was enacted by Decree-Law 72/83 of 6 July 1983 (implemented by Government Agreement 571/83 of 27 July 1983) and later on amended by the new government by Decree-Law 120/83 of 23 September 1983 which entered into force on 1 October 1983.

The former stamp tax on sales, services and imports was abolished as from 1 August 1983, i.e. the date of the entry into force of the VAT Law.[9]

Taxable persons

The tax is levied on individuals and companies carrying out taxable transactions within Guatemala.

Taxable transactions

Unless specifically exempted, taxable transactions include:

– transfers for consideration of goods;
– import and introduction of goods into the country;
– leasing of movable property with an option to purchase it;
– removal of goods from the enterprise for personal use or consumption;
– leasing of immovable and movable property by enterprises; and
– non-personal services rendered in the country by resident and non-resident enterprises.[10]

Transactions not subject to VAT

The following transfers of goods, inter alia, are not considered taxable transactions:

– capital contributions to trading and civil companies;
– mergers and transformation of companies;
– attributing of property upon dissolution or liquidation of companies, provided the receivers are taxable persons for VAT purposes;
– construction in general;
– land transportation services;
– inheritances, bequests and gifts;
– services rendered by banking and financial institutions, insurance, reinsurance and collateral guarantee and surety companies and by general warehouses;
– services rendered by non-university educational institutions;

- leasing of residential dwellings;
- lodging services during the period 1 October 1983 – 31 December 1984;
- immovable property; and
- securities represented by shares, bonds and debentures and certificates of insurance, reinsurance, surety and collateral guarantees, lottery, coins and bank notes and, in general, securities other than warrants issued by general warehouses where the property is transferred by endorsement of such warrants.

Exempt transactions

The following imports and sales are, inter alia, exempt from VAT:

- imports of accredited diplomatic missions and foreign officials of international organizations of which Guatemala is a member;
- temporary imports;
- introduction into Guatemala of tax-free goods (luggage and household goods);
- sale of goods expressly mentioned in the NAUCA (Central American Uniform Customs Nomenclature), such as:
  - basic foodstuffs;
  - live cattle;
  - flour and milk byproducts, etc.;
  - medicines and pharmaceutical products and some medical instruments;
  - basic agricultural products (from and for agriculture);
  - some agricultural tools;
  - educational materials;
  - products for general consumption;
  - publications;
  - petroleum and some byproducts thereof;
- export and re-export of goods.

Taxable base

For transfer of goods and for rendering of non-personal services within Guatemala, the taxable base is the net sales price (including consumption taxes applicable, excluding discounts granted); if there is no net price, the tax is calculated on the market value (i.e. arm's length price) as established by the General Directorate of Internal Revenue.

For imports and introduction into Guatemala of goods, the taxable base is the sum resulting from adding to the c.i.f. price the customs duties and other charges and duties paid on importation or introduction which have effectively been paid and entered in the import license or in the customs release.

Tax rate

Taxable transactions are subject to VAT at the rate of 7% (thus reducing the rate from the 10% originally established).

Tax assessment

The tax due is calculated as the difference between the amount of tax invoiced by a taxable person on each taxable transaction within the period of one calendar month to his customers and the total VAT invoiced to that taxable person by domestic suppliers or paid to customs authorities for imports on each purchase, as well as in consideration of non-personal services received. Thus the tax is computed, using the subtraction method, by crediting taxes paid on monthly purchases against tax liabilities arising from sales.

Tax period and declaration

The tax period coincides with the calendar month and a declaration must be filed with the local tax authorities within the first 20 calendar days of the following month; the return must be filed and the tax paid personally, thus if a declaration is sent by mail it is considered as not presented.

Tax refund

Where the difference between the amount of taxes paid and taxes received within a calendar month is positive for the Fisc, the taxpayer must pay it together with the monthly declaration. Where such a difference is positive for the taxpayer, the Fisc will compute it as a credit and the taxpayer may offset it against further VAT liabilities (unless the taxpayer can prove that there will be no further taxable transaction, in which case a cash refund is made).

IV. THE NEW HYDROCARBON LAW

With the purpose of increasing domestic production of crude oil to 30,000 bpd (barrels produced per day) by 1986 and of obtaining self-sufficiency in hydrocarbons, a new Hydrocarbon Law was enacted by Decree-Law 109/83 of 15 September 1983 which entered into force on 24 September 1983. The new law particularly focusses on attracting new foreign capital to carry out petroleum operations.[11]

Period of the contract

The period of the contract may not exceed 25 years; thus after 25 years all production reverts to the State.

State share scheme

The basic State share in hydrocarbon output has been reduced from 55% to 30%; the rate is progressive in relation to the number of barrels per day.[12]

Under the new Law, enterprises are allowed to recover all exploration and exploitation costs incurred in a con-

11. "Petroleum operations" refer to exploration, exploitation, development, production, processing, transportation and sale of hydrocarbons and oil products and in particular to exploration for and exploitation of crude oil, condensates and natural gas.

12. For contracts concluded before the entry into force of this new law (i.e. before 24 September 1983), the State share is as follows:
- natural gas output: 30%
- crude oil and condensates:

Output (bpd)	State share (in %)
first 5,000	30
next 5,000	40
next 10,000	50
next 30,000	60
more than 50,000	70

tract area before the State receives its share in production.[13]

However, the contractor is now required to drill at least 1 well during the first 3 years of the contract, plus 2 more wells per year during the next 3 years (i.e. 7 wells in 6 years).

State royalty scheme

Contractors of petroleum operations relating to exploration for and exploitation of crude oil, condensates and natural gas are required to pay to the State, prior to any cost recovery, a royalty calculated in kind (i.e. on the net output) or in cash (i.e. on the money value of the output), as follows:

- for natural gas and condensates: a minimum royalty of 5%;
- for crude oil, the minimum royalty is 20% which applies to oil of 30 degrees gravity, based on the monthly average gravity of the American Petroleum Institute (API); the royalty percentage is increased or reduced by 1% for each API degree of gravity in excess of or below 30 degrees, to a minimum of 5%.[14] A flat royalty of 35% is due for crude oil output from deposits which have not been declared "commercial", until their profitability is officially verified. The amount of the royalty is not considered a prepayment on account of contractor's company income tax.

Tax system

Contractors are subject to the company income tax, levied at rates between 5% and 42% on their taxable income. In calculating taxable income, contractors may deduct all exploration and exploitation costs as well as expenses and any losses incurred and, additionally, up to 33% of amounts invested in construction work for the welfare of their employees. Unused deductions may be carried forward and set off against future income until fully recovered.

Contractors benefit as well from exemptions, from VAT and import duties, as regards importation of material and equipment required to carry out petroleum operations. Dividends and profits distributed to non-resident shareholders or partners and head offices are also exempt from withholding tax. Furthermore, non-personal services rendered to the State are not subject to VAT.

Contractors are required to pay 100,000 Q upon conclusion of the contract, plus the annual charge established for each hectare included in the contract, instead of any other indirect tax, levy or charge.[15] Contractors are further required to pay an administrative duty to the Ministry of Energy and Mines for carrying out training and apprenticeship programs for Guatemalan personnel and for the development of technology relating to petroleum operations.[16]

Option to Guatemalan enterprises

Foreign contractors are required to give Guatemalans the option to participate in exploration for and exploitation of crude oil with a minimum share of 5% of the total amount during the first 3 years of the contract.

Exchange controls

Freedom from exchange controls is guaranteed; accordingly, capital invested and the principal of loans may be freely repatriated and profits, interest, royalties and similar payments may be freely remitted abroad.

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13. Formerly the State share in oil production had to be given to the State before the contractor could recover any cost incurred.
14. For contracts concluded before 24 September 1984, the 20% royalty is increased by 25% (i.e. basic royalty: 45%), which is increased or reduced by 1% for each API degree of gravity in excess of or below 30 degrees, subject to a minimum of 5%.
15. The total area of a contract may not exceed 300,000 hectares for land exploration, or 400,000 hectares for exploration in the territorial waters only or together with land; the maximum area for exploitation of petroleum operations is 150,000 hectares per contract.
For contracts concluded before 24 September 1983, this annual charge is 0.50 and 5 Q for each hectare of exploration and exploitation, respectively, increased by the annual inflation rate.
16. For contracts concluded before 24 September 1983, the administrative duty is 10,000 Q per month for each area of exploration or – whichever is higher – 350,000 Q per year for the total area of the contract, where such areas have been declared profitable, and 125,000 Q for the total area under exploration until its profitability is declared.

INDONESIA:

The Three Tax Reform Laws

Overhaul of an Inherited Tax System

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A. INTRODUCTION

A sweeping tax reform was launched with lightning speed at the end of 1983. Three tax reform bills were submitted to Parliament on 5 November 1983 and approved on 15 December 1983. These tax bills received the assent of the President of the Republic of Indonesia together with 30 implementing decrees and regulations on 31 December 1983. The tax reform laws are the General Provision and Procedure on Taxes Law (No. 6 of 1983, hereafter the General Tax Law), the Income Tax Law (No. 7 of 1983) and the Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods (No. 8 of 1983, hereafter Value Added Tax (VAT) Law).

The Income Tax Law and the General Tax Law are effective as of 1 January 1984 and the VAT Law will be effective as of 1 July 1984.

The Income Tax Law replaced the Corporate Income Tax Ordinance of 1925, the Individual Income Tax Ordinance of 1944 and the Tax on Interest, Dividends and Royalties of 1970. The VAT Law replaced the Sales Tax Law of 1951. The Net Wealth Tax Ordinance of 1932 and the Stamp Duty Ordinance of 1921, which are still effective, will also be replaced by new laws in the near future.

The 3 new tax reform laws overhauled the income and sales tax system inherited from the former Dutch East Indies Government. The old tax system, which was essentially based on former Dutch tax legislation, was no longer considered to be adequate considering the level of growth of the economy and the standard of living of the Indonesian people, both in view of national solidarity and the development of state finance. In addition, the preamble to the Tax Reform Law stated that this tax system was not suited to activate full participation by all groups of taxpayers in increasing national revenue so badly needed to achieve progress and increased development in the framework of strengthening national stability.

The President of Indonesia stated that these tax reform laws are one of Indonesia's great national works, not only because they replaced tax laws inherited from the colonial period, but also because they are modern tax laws and stem from Indonesia's own identity.[1]

The aim of the tax reform laws is to simplify the existing tax system through simplification of the types of tax, of the tax rates and of the methods of paying taxes.

Simplification is considered the key to improving compliance and administration. A broad tax base and fewer tax exemptions and tax reductions will, it is hoped, result in higher revenue receipts. The new tax system aims at increasing revenue receipts from the non-hydrocarbon (oil and gas) sector, mainly during the Fourth Five-Year Development Plan (1 April 1984 - 31 March 1989).

At present, more than 68% of total revenue receipt is derived from the corporate income tax imposed on foreign oil companies, whereas the non-hydrocarbon sector yields only about 6%.[2]

In the first Budget under the new tax reform laws (1984/85) an increase of revenue from the non-hydrocarbon sector of 5.7 billion rupiahs (17%) is estimated over 1983/84.[3] Taxes levied in this sector comprise, inter alia, corporate and individual income tax, import and excise duties, export tax and land tax. The yield of corporate income tax will increase by 114.1%, the individual income tax by 105.1%, VAT and luxury sales tax by 21.9% and export tax by 40.3% over the 1983/84 tax revenue estimates.[4]

B. INCOME TAX

The Income Tax Law of 1984 covers both individual and corporate taxpayers, as well as subjecting dividends, interest, royalties, rents and fees for services to income tax by means of a withholding tax.

Taxable persons

Subject to the income tax (pajak penghasilan) are individuals (private persons and entrepreneurs), companies as well as other entities and undivided estates.

Cooperative associations, foundations and permanent establishments of foreign companies are also taxable persons.

Residents and non-residents

Taxpayers are divided into residents and non-residents (both individuals and companies).

An individual is a resident of Indonesia if he is present in Indonesia for more than 183 days in a 12-month period or

1. "Suharto Looks to Non-Oil Areas to Fund Next Indonesian Budget", *The Asian Wall Street Journal,* 10 January 1984.
2. See: Indonesia, Section A. Economic Analysis: the tax system in figures. In: *Taxes and Investment in Asia and the Pacific.* International Bureau of Fiscal Documentation. For a description of the tax system prior to the new tax reform laws, see Section C.
3. Susumu Awanohara and Manggi Habir, "A precarious balance. Indonesia launches a new five-year plan and struggles to raise money", *Far Eastern Economic Review,* 19 January 1984, at 72.
4. "Indonesia's 1984 Budget Reflects Caution Amid Slow Economic Recovery", *Business Asia,* 20 January 1984, at 20.

if he is present in Indonesia with the intention of becoming a resident of that country. A permanent establishment of a foreign company is a resident taxpayer if such establishment is located in Indonesia. Foreigners resident in Indonesia are also resident taxpayers.

A company created by virtue of Indonesian law is deemed to be a resident company as is a company which has its place of effective management in Indonesia.

The Director General of Taxes is authorized to decide whether an individual or company is domiciled or has its place of effective management in Indonesia, taking into account the facts in each individual case. Taxpayers who do not meet the requirements to be considered a resident of Indonesia are non-residents for income tax purposes, meaning that they are only subject to income tax on income derived or received in Indonesia. Resident taxpayers are subject to income tax on their world-wide income.

Permanent establishment

The concept of permanent establishment is defined as a fixed place of business which is regularly used by a company not established in Indonesia or an enterprise not domiciled in Indonesia to carry on business operations in Indonesia. A permanent establishment includes a branch, an agent representing the enterprise, a factory, a warehouse, a construction project, a mine, quarry or other place of extraction of natural resources, fishery activities, the use of experts and the supply of services in any form by an employee or other person or company of a non-independent status acting on behalf of a non-resident company or enterprise in Indonesia. Non-resident insurance companies which collect insurance premiums or take risks with respect to objects insured in Indonesia are deemed to have a permanent establishment in that country.

Force of attraction rule

Once a permanent establishment is deemed to exist in Indonesia, the next issue is determination of the taxable income of the permanent establishment. In defining this tax base, Art. 5 of the new Income Tax Law provides that a permanent establishment is subject to tax with respect to:

(1) income from business activities carried on by such permanent establishment and income from property managed or owned through it;
(2) income of the non-resident head office and other non-resident entities having a special relationship to that non-resident company from business activities or sales of goods and/or rendering services carried out by the permanent establishment in Indonesia, except income subject to the Indonesian income withholding tax which is levied as a final tax on dividends, interest, royalties, rents, etc.

The taxable base of a permanent establishment situated in Indonesia of a non-resident company or non-resident individual includes *any* income derived from business activities carried on or income from assets managed or controlled or owned through that permanent establishment whether the activities are undertaken in or outside of Indonesia or whether the assets are situated in or outside that country. The explanatory memorandum to the Income Tax Bill No. 3263 clarifies that, for example, income from a participation in a foreign company through a permanent establishment situated in Indonesia is subject to Indonesian income tax. It is further clarified that if a non-resident company with a permanent establishment in Indonesia carries on the same kind of business activities in that country (but not through its permanent establishment) of if it sells similar goods in Indonesia or renders similar services as the permanent establishment (but not using the permanent establishment for such sales or supply of services), the company will be subject to Indonesian income tax with respect to income thus derived. The same holds true for Indonesian-source income derived from business activities carried on by other non-resident enterprises which are affiliated to the non-resident company and for income derived from the sale of goods or the supply of services similar to the goods sold by the permanent establishment or similar to the services rendered by it. In other words, the taxable base of the permanent establishment includes not only Indonesian-source income directly derived through the permanent establishment but also income derived by non-resident subsidiaries of the non-resident company. The question has been asked whether the new Indonesian tax provisions imply a sort of unitary taxation rule as applied by California and other states of the United States of America.[5] However, the tax authorities have stressed that the "force of attraction rule" adopted by the Indonesian Income Tax Law will only include the right to tax any Indonesian-source income, and not non-resident companies' world-wide income as was first feared by multinationals.[6]

The concept of income

According to the explanatory memorandum to the Income Tax Bill, the Income Tax Law defines the concept of income as any *increase of economic capability* as opposed to the concept of having certain "sources of income" as was the case under the former legislation. Art. 4 of the Income Tax Law defines income as any increase in economic capability received or accrued by a taxpayer whether originating within or without Indonesia, that is used for consumption or that increases the wealth of such a taxpayer, under whatever name or form.

Income includes wages, salaries, pensions, lottery prizes, gross profits from business, gains from the sale or transfer of property, dividends, interest, royalties, rents, etc. as listed in Art. 4 of the Income Tax Law. The list of items of income is not exhaustive. Gifts or donations that are not related to a business or a profession of the parties involved; inheritances; payments from an insurance company because of accident, illness or death of the insured person; and payments from scholarship insurance are not regarded as income.

5. See James C. Redmond, "The Unitary System of Taxation. Identification of the Source of Income, 35 *Bulletin for International Fiscal Documentation* 3 (1981) 99 - 107.
6. See Manggi Habir, "Sweetening a bitter pil", *Far Eastern Economic Review*, 1 December 1983, at 56.

Income tax levied on interest from time deposits and other savings will further be regulated in a Government Regulation.

Under the former Corporate Income Tax Ordinance of 1925, the term "profit" was defined as the total net sum of the benefits derived under any name and in any form from a business and from capital used outside the business (Art. 3(1)). This definition of profit was, according to the Explanatory Memorandum in *Bijblad* 10,797, based on an "objective profit concept" (materieel begrip). The term "objective profit" meant that computation of the profit could not be influenced by the viewpoint or interpretation of the taxpayer or by the method or the manner of recording. It was immaterial what name the taxpayer gave to a certain receipt or expense or to any particular form of transaction, even if this was in conformity with the Articles of Incorporation or based on a decision approved by the general meeting of shareholders. The decisive factor was the substance of the transaction resulting from the facts rather than its form. The way of ensuring "objective profit" was to use the financial statement prepared for tax purposes set out by the law. The tax administration could then determine the income on the basis of the provisions of the law and, under the concept of "objective profit", it had the right to adjust the financial statements of companies if there were deviations not in accordance with the provisions of the law. Consequently, "bargaining" about tax assessment between the taxpayer and the tax officials for mutual benefit was common practice. In an effort to eliminate such negotiations, the Indonesian Government introduced a tax incentive package designed to improve tax compliance by corporate taxpayers which is known as the "27 March 1979 Tax Package". Those Indonesian companies which use an Indonesian independent public registered accountant to prepare their audit reports are granted a reduced corporate income tax and tax amnesty.[7]

It is believed that simplification in the form of a single income tax rate and the granting of only a few exemptions and reductions of income tax will enhance taxpayer compliance and possibly eliminate "tax bargaining".

The Explanatory Memorandum stresses that the concept of income under the new Income Tax Law includes any increase of "economic capability" derived or received by a taxpayer within and outside Indonesia which can either be used for consumption by the taxpayer or which increases his wealth. The Law only lists profit from business, salaries, interest, dividends, royalties, rents, remuneration etc. However, the concept of income includes any income derived or received from Indonesian and foreign sources which increases wealth. The economic benefit received or obtained by a person or body is the best measurement for a taxpayer to take part in bearing the expenses necessarily required by the Government in financing its routine and development expenses. Consequently, multinationals with a subsidiary in Indonesia have expressed their concern that it is the intention of the new Income Tax Law to take into account the worldwide income of the group of multinational companies as is the case under a unitary tax.[8] Forthcoming implementing regulations will clarify the meaning of the legislature.

Deductible expenses

In general, expenditure incurred for purposes of gaining, producing and collecting income and maintaining sources of income are allowable as deductions in computing the net income amount.

The overhead cost of foreign companies may not be attributed to their permanent establishment in Indonesia and deducted by it. Donations are not deductible expenses. Benefits in kind provided to employees by a company are no longer deductible as a business expense (e.g. free housing, free cars, travel allowances, etc.). However, free housing in hardship areas will be a deductible expense if so stipulated by a Decree issued by the Minister of Finance (No. 960/KMK.04/1983 dated 31 December 1983).

Depreciation

There are different categories for depreciation rates of fixed assets depending on the economic life of the asset. For fixed assets (other than buildings) having a useful economic life of:
- less than 4 years: the rate is 50% (declining balance method);
- between 4 and 8 years: the rate is 25% (declining balance method);
- more than 8 years: the rate is 10% (declining balance method).

Buildings are depreciated at 5% per annum calculated using the straight-line method (see Minister of Finance Decree 961/KMK.04/1983 dated 31 December 1983 for detailed lists).

There is no accelerated depreciation or investment deduction.

Losses

Losses incurred in a certain year may be carried forward to the following 5 years and deducted from the profits of these years. However, by virtue of a Decree issued by the Minister of Finance, a loss carry-forward of 8 years applies to industries indicated by the Minister. They include hard mining and plantations growing hardy plants (Minister of Finance Decree 958/KMK.04/1983 dated 31 December 1983).

There is no carry-back of losses or carry-forward of initial losses.

Income tax rates

A single income tax rate is applicable to individuals and companies. There are no reduced income tax rates as was the case under the previous Income Tax Law. Thus no reduced income tax rates and other tax incentives are granted under the new Income Tax Law for purposes of

7. Jap Kim Siong, "Indonesia: Tax Incentive Package to Support the Third Five-Year Development Plan (1979-1984)", 34 *Bulletin for International Fiscal Documentation* 3 (1980), 95 - 105.
8. See Susumu Awanohara, "The tax man cometh. Indonesia plans a radical reform to boost public-sector revenues", *Far Eastern Economic Review,* 1 December 1983 at 56.

domestic as well as foreign investment laws, nor do reduced rates apply to companies going public and companies using certified public accountants to audit their financial statements. However, reduced income tax rates and other incentives granted under the former tax law for a limited period of time remain in force until the period elapses.

The income tax rates (both individuals and companies) are:

- income not exceeding 10,000,000 Rp. 15%
- on the next 40,000,000 Rp. 25%
- on that part of income in excess of 50,000,000 Rp. 35%

Oil, gas and mining companies

Oil, gas and mining companies which have concluded production-sharing contracts and work contracts remain subject to the Corporate Income Tax Ordinance of 1925 and the Tax on Interest, Dividends and Royalties of 1970 (including tax rates) until the contracts involved have elapsed.

Personal deductions

Individuals are entitled to personal deductions from the net income amount before the income tax rates are applied:

- for the taxpayer 960,000 Rp.
- for his spouse 480,000 Rp.

If the spouse is earning an income apart from that of her husband, the deduction is increased to 960,000 Rp. For any dependent child and other person in the family of the taxpayer a deduction of 480,000 Rp. is given with a maximum of 3 times 480,000 Rp. or 1,440,000 Rp.

Withholding taxes

As indicated above, the tax on interest, dividends and royalties was abolished as of 1 January 1984. However, as of that date, a withholding tax is to be applied to dividends, interest, rents, royalties, technical and managerial fees as well as branch profit transfers under the 1984 Income Tax Law. The *resident* withholding tax rate (i.e. if the recipient is a resident) is 15% to be withheld by any resident taxpayer from the gross amount of dividends, interest, royalties, etc. paid to the recipient. The withholding tax is creditable against the ultimate income tax payable by the recipient. However, a recipient which is a bank or financial institution or is a resident company which owns at least 25% of the paid-in capital of the distributing company paying the dividends, is exempt from the resident withholding tax.

The *non-resident* withholding tax rate is 20% of gross income, to be withheld by the resident payor to a non-resident recipient. This withholding tax also applies to the gross amount of profits transferred by an Indonesian branch of a non-resident company to its foreign head office. The 20% withholding tax is a final tax.

Interest from time deposits and TABANAS and TASKA saving schemes remain exempt from withholding tax (Government Regulation 37 of 1983 dated 31 December 1983).

Implementing decrees and regulations with respect to the corporate income tax, individual income tax and the tax on interest, dividends and royalties shall remain in force so far they are not contradictory to the new Income Tax Law and have not yet been replaced by new implementing decrees and regulations.

MPS/MPO system

The MPS/MPO system of collecting tax has been substantially modified.[9] As of 1 January 1984, the MPO tax (withholding tax) has been abolished and replaced by the income tax under the 1984 Income Tax Law. The present income withholding tax is levied at the rate of 1.5% (was 3% MPO tax), sales tax remains 2.5%.

The MPO tax on imports has also been abolished and replaced by an income tax on importation comprising two rates:

- 2.5% of the c.i.f. price for imports using an importer's identification number (API), importer's provisional identification number (APIS) and registered importer's identification number (APIT);
- 7.5% of the c.i.f. price for imports without API, APIS and APIT.

The MPO tax on exports is also abolished as of that date. MPO tax on exports levied after 1 January 1984 must be refunded.

Tax collection has been simplified by the introduction of a self-assessment system. A resident taxpayer must file an annual tax return, calculate his own tax liability and pay the tax to the Treasury via the post office or giro. No tax assessment will be made by the tax administration unless the taxpayer has declared his income incorrectly. Non-resident taxpayers are not required to file a tax return but shall be taxed by a withholding tax at source on income derived from Indonesia as a final tax.

C. VALUE ADDED TAX

The Value Added Tax (VAT) Law of 1984 will enter into force on 1 July 1984 and will replace the Sales Tax Law of 1951, as amended.

The VAT Law comprises a value added tax on goods delivered and services rendered by an entrepreneur within the scope of his business. VAT is also levied at importation of goods. In addition, a one-point sales tax on luxury goods is levied either at the manufacturing level, at delivery or at importation of the luxury goods into the customs territory of Indonesia. Consequently, the law is called the "Law on Value Added Tax on Goods and Services and the Sales Tax on Luxury Goods".

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9. The MPS (Menghitung Pajak Sendiri) and MPO (Menghitung Pajak Orang Lain) are systems of tax collection based on Law 8 of 1967 and its principal implementing regulation, Government Regulation 11 of 1967. The MPS is a system of self-assessment whereas the MPO is a system of withholding tax by tax collectors appointed by the Minister of Finance. Under the new tax system the Minister of Finance may still appoint tax collectors but only importers and Government bodies qualify (Decree of the Minister of Finance 965/KMK.04/1983 dated 31 December 1983).

Thus, VAT on goods and services and the sales tax on luxury goods are two different kinds of turnover taxes on domestic consumption and on importation of goods.

All persons or entities which manufacture, import or trade goods or supply services in Indonesia are subject to VAT. Also the delivery of goods by entrepreneurs who act as agents or distributors and/or retailers as well as contractors or who lease goods are subject to VAT. VAT must be computed on the sales price of goods or services supplied. Any VAT invoiced to the entrepreneur may be credited against the VAT due.

Exempt from VAT are small entrepreneurs having an annual turnover not exceeding 24 million rupiahs or who have invested capital of not more than 10 million rupiahs.[10]

The sales tax on luxury goods is a turnover tax additional to the VAT.

Rates

The VAT has a basic tax rate of 10% which may be reduced to 5% or increased to 15% for certain goods.

The sales tax on luxury goods is at a rate of 10% or 20% which may be increased to a maximum of 35%.

Export of goods is zero rated.

Existing decrees and regulations implementing the former sales tax will be abolished with some likely to be replaced by new ones.

D. GENERAL TAX LAW

The General Tax Law of 1984 basically provides administrative rules and is intended to streamline tax collection and refunds of income tax and VAT.

A person subject to tax must register himself with the Director General of Taxes. Failure to comply with this requirement may result in imprisonment up to a maximum of 2 years or a fine up to twice the amount of the tax not reported. Taxpayers must file a tax return with the tax office having jurisdiction over the area in which the taxpayer is domiciled and pay the tax by self-assessment. The tax administration will consider the tax assessment to be final unless (with a statutory limit of 5 years) certain facts have been found deviating from the rules in effect, for instance, if the books and records of the taxpayer are not properly kept, a tax return is not filed in time, or the tax credit in the VAT system is not properly calculated, etc.

Requests for refunds of overpaid tax or protests against an assessment deviating from the tax return must be decided by the Director General of Taxes within a period of 12 months. Failure to meet this deadline will mean that the request and/or protest is automatically accepted. Filing the protest against the assessment, however, does not result in postponing the payment of the tax assessed.

E. UNILATERAL RELIEF

The Income Tax Law provides a tax credit for foreign income tax paid (cash basis) against Indonesian income tax (accrual basis) payable on world-wide income of a resident taxpayer. However, the credit for foreign income taxes paid may not exceed the Indonesian tax payable on that foreign income received, calculated in conformity with Indonesian tax law. The former "exemption with progression" rule has now become obsolete.

F. DOUBLE TAXATION TREATIES

Comprehensive income tax treaties concluded by Indonesia are still effective. However, Indonesia has expressed its wish to renegotiate these treaties in order to adjust them to the new situation.

Treaty with	*concerning*	*signed*
Belgium	income, capital	13 November 1973
Canada	income, capital	16 January 1979
France	income	14 September 1979
German Fed. Rep.	income, capital	2 September 1977
Japan	income	3 March 1982
Netherlands	income, capital	5 March 1973
Philippines	income	18 June 1981
Thailand	income, capital	25 March 1981
United Kingdom	income, capital	13 March 1974

10. Decree of the Minister of Finance 967/KMK.04/1983 dated 31 December 1983.

Philippine Investment Policy Act of 1983

(Batas Pambansa Blg. 391)

By Francisco G. Tagao*

SALIENT FEATURES OF THE INVESTMENT POLICY ACT OF 1983

Batas Pambansa Bilang 391, otherwise known as the Philippine Investment Policy Act of 1983 (IPA), was enacted into law on 28 April 1983. The Law was immediately effective and was later implemented by "Rules and regulations to implement Batas Pambansa Bilang 391". It amended Presidential Decree 1789, otherwise known as the Omnibus Investments Code and is intended to rationalize the major incentives granted by the Philippine Board of Investments (BOI). Since the passage of the Investment Incentives Act in 1967, the BOI has encountered many problems in the administration of the incentives given to registered enterprises. This resulted in the consolidation and revision of the said law and subsequent incentive acts into P.D. 1789. Notwithstanding the consolidation of the major incentives laws in 1981 through P.D. 1789, the BOI felt that there was still room to improve the incentives extended to registered enterprises. It is for this reason that the Philippine legislature, through the initiative of the BOI, enacted the Investment Policy Act of 1983.

One of the salient features of the IPA is that the granting of incentives is primarily based on *performance*. This resulted in the elimination of certain incentives and/or the revision of existing incentives in order that the granting thereof would be tied up with the performance of the registered enterprises. It also gave rise to the introduction of two new incentives, i.e. the tax credit for net value earned and the tax credit for net local content on exports which are related to the performance of the registered enterprise. Generally, enterprises registered under the IPA will no longer be entitled to incentives under other incentive laws. The only exception is that enterprises engaged in the semi-conductor industry still retain the incentives granted under Executive Order 815. This might be due to the fact that this industry is primarily geared toward exports which generate substantial amounts of foreign exchange earnings to service our external obligations.

Another highlight of the IPA is that the tax credits granted under the Act are expressly considered not to be taxable income of the grantee. Under the former laws, the Philippine Revenue Office considered tax credits granted under the incentive laws as taxable income because they resulted in a previous tax benefit to the grantee in the form of a deduction of taxable income.[1] We have contested the position of the Internal Revenue Office because to impose tax on such tax credits under the incentive laws would, in effect, reduce the incentives given and would to a certain extent be a disincentive. It is because of this position of the Revenue Office that the IPA expressly stated that the tax credits granted under the Act are not taxable to the enterprise.

Another feature of the tax credits given under the IPA is that the tax credits on withholding tax on interest on foreign loans, tax credit on purchase of domestic capital equipment and tax credit on taxes and duties paid on raw materials used in the manufacture of export products may only be transferred to a BOI-registered enterprise while the tax credits on net value earned and net local content may be transferred to a domestic producer of the raw materials and/or components who are suppliers of the registered enterprise which, in turn, may transfer to its own suppliers, regardless of whether it is registered with the BOI or not. A significant feature of the tax credit is that it has a validity of 10 years and, therefore, if not used immediately, it can be used in the future when the enterprise has tax liabilities. However it can in no case go beyond those 10 years.

The IPA revised the incentives given to (i) domestic producers, (ii) new and expanding export producers, (iii) existing direct export producers and (iv) indirect export producers. The incentives given to registered agricultural enterprises have not been affected. The same is true with respect to service exporters and export traders, except that there is a clarification of the reduced income tax incentive that could be passed on by the export trader to another BOI-registered export producer. It also extended the incentives to energy saving projects and to industry rationalization programs. It likewise gave an investment tax allowance to Philippine nationals investing in National Development Fund Certificates issued under Executive Order 842 in the form of a deduction from taxable income to the extent of actual investment but not to exceed 10% of taxable income.

We now give a comparison of the incentives given to registered enterprises under the IPA and the Omnibus Investments Code as follows.

Note: Taxpayers entitled to a tax credit receive a tax credit certificate which they may use to pay taxes due to the national Government. These certificates are to some extent transferable.

* Tax Division, Sycip, Gorres, Velayo & Co., Manila.

1. The tax credit is granted to a registered enterprise for taxes actually paid by it which were previously claimed as deduction from taxable income by such enterprise, either as an outright deduction from gross income or as part of the goods sold and, therefore, reduced gross profit upon the subsequent sale of the products to which they pertained.

DOMESTIC PRODUCERS

IPA Scheme	P.D. 1789
1) Compensating tax and tariff duty exemption on imported capital equipment for a period of 5 years from date of registration, 50% for non-pioneer and 100% for pioneer firms. Taxes and duties waived to be refunded by deducting from tax credits on net value earned and net local content. The obligation to refund the taxes and duties waived is reduced by any exports.	1) Compensating tax and tariff duty exemption on imported capital equipment for a period of 7 years from date of registration, 50% for non-pioneer and 100% for pioneer firms. There is no obligation to refund the taxes and duties waived.
2) Tax credit on the purchase of domestic capital equipment equal to the taxes and duties waived if imported. It is available for a period of 5 years from the date of registration. There is an obligation to refund the tax credit by deducting it from tax credits on net value earned and net local content that will be earned. The obligation to refund the tax credit is reduced by any exports. There is no tax credit given to the domestic manufacturer of the capital equipment.	2) Tax credit on the purchase of domestic capital equipment equal to taxes and duties to be paid if equipment is imported. The domestic manufacturer is entitled to 50% of the tax given to the registered enterprise. It is available for a period of 7 years from the date of registration. There is no obligation to refund the tax credit granted.
3) Tax credit on net value earned: 5% for non-pioneer and 10% for pioneer firms for 5 years from date of commercial operation, except in case of previous pioneer registration for an identical product or process, succeeding pioneer enterprise entitled to tax credit for duration of first registration and thereafter to 5%. Net value earned means sales less cost of raw materials and components, factory supplies and factory utilities and depreciation of capital equipment. It is transferable to a domestic raw material supplier.	3) Not available.
4) 10% tax credit on net local content for a period of 5 years from commercial operation and for another 5 years based on increment in real terms (without inflation) over the average of the net local content for the immediately preceding 3-year period. It is transferable to a domestic raw material supplier of domestic enterprise.	4) Not available.
5) Net operating loss carry-over is clarified by including financial charges.	5) Although net operating loss carry-over did not expressly include financial charges, the BOI allowed inclusion of financial charges in computing operating loss carry-over provided that they were related to the registered operation.
6) Tax credit for withholding tax on interest on foreign loans granted only to registered pioneer enterprises to cover foreign loans entered into within 5 years from date of registration or commercial operation. Loans must be used to finance new or expanding project. It is required that no tax credit is available to original lender remittee.	6) Tax credit for withholding tax on interest on foreign loans granted to all registered domestic producers without time limit. It is available to registered enterprises even if a tax credit is available to the original lender remittee provided that no tax credit is available to the successor lender remittee if loan transferred subsequently.
7) Special tax credit on taxes and duties on raw materials for export products.	7) Available.
8) Permission to employ a limited number of foreign nationals.	8) Available.
9) Anti-dumping protection.	9) Available.
10) Protection from government competition.	10) Available.
11) Protection of patents and other proprietary rights.	11) Available.
12) Post-operative tariff protection for pioneer firm.	12) Available.
13) Not available.	13) Accelerated depreciation.
14) Not available.	14) Deduction of organizational and pre-operating expenses over a period of not more than 10 years.
15) Not available.	15) Incentives for necessary infrastructure and public and major facilities.
16) Not available.	16) Deduction for expansion reinvestment allowance.
17) Not available.	17) Additional deduction for labor training expenses.
18) Not available.	18) Exemption from all taxes under the Tax Code, except income tax, of pioneer firms on a diminishing basis.
19) Not available.	19) Reduced income tax incentive for limited exports.

EXPORT PRODUCERS (new and expanding)

IPA Scheme	P.D. 1789
1) Full and non-repayable compensatory tax and tariff duty exemption on imported capital equipment for a period of 5 years from registration date. If export commitment not met for any taxable year during first 5 years of operation, 20% of	1) Full compensating tax and tariff duty exemption on imported capital equipment for a period of 7 years from date of registration. No obligation to refund taxes and duties waived.

IPA Scheme (cont.)	P.D. 1789 (cont.)
value of exemption shall be deducted from value of tax credit on net value earned and net local content. If tax credit earned is insufficient, balance shall be paid in cash or may be deferred for succeeding year subject to payment of interest.	
2) Tax credit on the purchase of domestic capital equipment equal to the value of the tariff duties and compensating tax that would have been waived had they been imported within 5 years from registration date. There is no obligation to refund tax credit granted. Domestic manufacturer of capital equipment not entitled to tax credit.	2) Tax credit on the purchase of domestic capital equipment equal to taxes and duties to be paid if equipment is imported. Domestic manufacturer of equipment is entitled to 50% of tax credit given to registered firm. It is available within 7 years from date of registration.
3) Tax credit on net value earned available within 5 years from commercial operation, 5% for non-pioneer and 10% for pioneer projects, except that for pioneer export producers exporting 100% of production, the period of availability of the incentive shall not be shortened by the existence of the first registered enterprise.	3) Not available.
4) Tax credit equal to 10% of net local content for 5 years from commercial operation. Net local content means value of export sales less depreciation of capital equipment and value of imported raw materials, components, supplies associated with export sales/registered operations. Also excluded are indigenous commodities available under clearly more favorable terms in the local market than in the international market but taking into account competitiveness of final export product. It is available for another 5 years based on the increment in real terms (without inflation) over the average net local content for the immediately preceding 3-year period.	4) Not available.
5) Net operating loss carry-over. Same as that granted to domestic producer.	5) Net operating loss carry-over. Same as that granted to domestic producer.
6) Tax credit for withholding tax on interest on foreign loans. Same as that granted to domestic producer.	6) Tax credit for withholding tax on interest on foreign loans. Same as that granted to domestic producer.
7) Special tax credit for taxes and duties on raw material materials used in the manufacture of export products.	7) Available.
8) Exemption from export tax duty, impost and fee, including wharfage fee, on export of non-traditional registered export products.	8) Exemption from export tax, impost and fee.
9) Permission to employ a limited number of foreign nationals.	9) Available.
10) Anti-dumping protection.	10) Available.
11) Protection from government competition.	11) Available.
12) Not available.	12) Deduction of organizational and pre-operating expenses over a period of not more than 10 years.
13) Available.	13) Accelerated depreciation.
14) Not available.	14) Incentives for necessary infrastructure and public and major facilities.
15) Not available.	15) Deduction for expansion reinvestment allowance.
16) Not available.	16) Additional deduction for labor training expenses.
17) Not available.	17) Exemption from all taxes under Tax Code, except income tax, of pioneer firms on a diminishing basis.
18) Not available.	18) Exemption from sales tax on indirect exports.
19) Not available.	19) Reduced income tax incentive.
20) Not available.	20) Additional deduction for use of new brand name based on incremental exports.
21) Not available.	21) Available.
22) Anti-dumping protection.	22) Available.
23) Protection from government competition.	23) Available.
24) Protection of patents and other proprietary rights.	24) Available.
25) Post-operative tariff protection for pioneer firms.	25) Available.

EXISTING DIRECT EXPORT PRODUCER

IPA Scheme	P.D. 1789
1) Tax credit equal to 10% of net local content of exports based on increment in real terms (without inflation) of each year's export sales during the 3-year period preceding date of registration. It is available for a period of 5 years from regis-	1) Not available.

IPA Scheme (cont.)	P.D. 1789 (cont.)
tration date. A similar tax credit for the next 5 years is given, based on increment in real terms (without inflation) on the average net local content for immediately preceding 3 years of enjoyment of incentive.	
2) Exemption from export tax, duty, impost and fee on export of non-traditional registered export products.	2) Available.
3) Special tax credit on raw materials used for exports.	3) Available.
4) Not available.	4) Reduced income tax incentive.
5) Not available.	5) Exemption from sales tax on indirect exports.
6) Not available.	6) Additional deduction for use of new brand name based on incremental exports.
7) Not available.	7) Tax and duty-free importation of equipment for upgrading product to export quality.

INDIRECT EXPORT PRODUCER

IPA Scheme (cont.)	P.D. 1789 (cont.)
1) Tax credit equal to 5% of net value earned but limited to that associated to the production of indirect exports. It is based on increment in real terms (without inflation) of each year's export sales over average export sales during 3-year period immediately preceding availability of incentive. It is available within 5 years from registration date.	1) Not available.
2) Tax credit for taxes and duties on raw materials used in the manufacture of export products.	2) Available.
3) Not available.	3) Exemption from sales tax on indirect exports.

EXPORT TRADERS

There is no change in the incentives given to export traders except that the percentage of reduced income tax incentive that they may pass on to an export producer which channels its exports through the export traders has been increased from 10% to 50% of the 20% RIT deduction.

IPA Scheme (cont.)	P.D. 1789 (cont.)
SPECIAL INCENTIVES	
A. Energy saving projects	
1) Tax and duty-free importation of capital equipment for energy-saving projects available for a period of 5 years from registration date to replace, modernize and/or supplement existing facilities at the rate of 50% for non-pioneer project and 100% for pioneer project. There is no obligation to refund taxes and duties waived.	1) Available.
2) Tax credit on purchase of domestic capital equipment equal to amount of tariff and compensating tax had they been imported. It is available for a period of 5 years from registration date. There is no obligation to repay taxes and duties given as tax credit.	2) Available.
B. Industry rationalization programs	
1) If new capacities are being put up or existing production capacities are expanded, enterprise entitled to all incentives extended to registered domestic producers.	1) Available.
2) If no resulting increase in capacity, enterprise entitled only to tax and duty-free importation of capital equipment and tax credit on domestic capital equipment.	2) Available.
3) No repayment of taxes and duties waived on imported capital equipment and tax credit for domestically procured equipment.	3) Available.
4) If production principally for export, enterprise entitled to similar incentives granted to registered export producers.	4) Available.

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FOR FURTHER INFORMATION PLEASE WRITE TO:

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

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

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

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CUMULATIVE INDEX 1984 – Nos. 1 & 2

UNITED KINGDOM:

Tax Planning after Dawson

By Malcolm Gammie

The tax which each individual is bound to pay ought to be certain, and not arbitrary. (Adam Smith, *The Wealth of Nations*)

Three years ago, in *WT Ramsay Ltd* v. *CIR* [1981] STC 176, the Judicial Committee of the House of Lords, the ultimate appellate Court in the U.K., adopted a new approach to tax avoidance schemes which was relied on by the House in the subsequent case of *CIR* v. *Burmah Oil Co Ltd* [1982] STC 30. In their most recent decision, *Furniss* v. *Dawson,* the Law Lords have reaffirmed most emphatically their commitment to this approach. This article examines the current state of U.K. tax law and the future prospects for tax planning and tax avoidance in the U.K.

THE EMERGING PRINCIPLE

The new approach has been described as an "emerging principle". In *Dawson's* case, Lord Bridge said:

> I shall attempt no exhaustive exposition of all the criteria by which, for the purpose I suggest, form and substance are to be distinguished. Once a basic doctrine of form and substance is accepted, *the drawing of precise boundaries will need to be worked out on a case by case basis.*

This was echoed by Lord Scarman in his judgment where he said that ". . . . every man is entitled if he can to order his affairs so as to diminish the burden of tax. The limits within which this principle is to operate *remain to be probed and determined judicially.*"

The House of Lords has shown quite clearly its determination to counter certain tax savings devices and, it is considered, will be willing to extend or "bend" the principles already enunciated, if necessary, in order to counter further schemes. Just as it is now impossible to rely completely on literal analysis and detailed interpretation of the taxing statutes, so the judgments delivered by their Lordships in the three cases mentioned above must be read in their particular contexts. Exactly how the new approach may be applied to other tax saving devices will only emerge as more cases come before the Courts. Subject to that warning, where does U.K. tax avoidance appear to stand at present?

THE DAWSON APPROACH

In the light of the *Ramsay* case, and the subsequent decision in *Burmah,* but prior to the *Dawson* decision, the following general features of the Courts' new approach seemed to have been identified:

(1) in order to be caught the scheme had to be "pre-packaged", in that, although it might be tailor-made for the taxpayer and his particular circumstances, it consisted of a number of pre-planned transactions executed according to a pre-arranged timetable;

(2) whether or not there was any contractual obligation to do so, it had to be of the essence of the scheme that it was carried through from beginning to end, and that the transactions involved, while real (rather than sham) transactions, had no significance except as steps in the whole scheme;

(3) while actual sums of money might be involved, and gains and losses might arise in the transactions when viewed individually, the money, the gains and the losses had to have no commercial reality, in the sense that the taxpayer's financial position at the end of the scheme would be unaltered (save for any costs involved, such as fees paid directly or indirectly); the gain and the loss would cancel each other out and any actual money involved would have gone full circle; and

(4) the transactions forming the scheme had *in themselves* to have no commercial motive, being designed only to avoid tax. The transactions might, however, form part of some larger commercial purpose.

The third of these features was generally assumed to mean that the new approach was limited in its application to "self-cancelling" schemes, i.e. those bringing about no real change in the financial and legal positions of the parties involved. This view has, however, been rejected decisively in *Dawson's* case. In that case D transferred shares to G Ltd in exchange for G Ltd's shares. G Ltd then immediately sold the first shares to W Ltd. Although the capital gains legislation (as it stood at the time – anti-avoidance provisions were subsequently introduced) regarded D as not disposing of his shares on the share exchange with G Ltd (so that his gain was deferred), the Court treated D as disposing of the shares direct to W Ltd. It disregarded the interposition of G Ltd, even though G Ltd actually received the sale proceeds and the scheme was not self-cancelling.

In effect, the *Dawson* case indicated that, while point (3) above was one that was present in both *Ramsay* and *Burmah,* it was *not* an essential element of the new approach. The remaining criteria (1, 2 and 4 above) have, however, been confirmed. For the new approach to be adopted:

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(1) there must be a pre-ordained series of transactions which can, effectively, be looked at as one single composite transaction; and
(2) some of the steps in the series of transactions must have no purpose other than the avoidance of a liability to tax.

Where these two ingredients are found, the steps which are inserted for no other purpose than to avoid tax are to be disregarded for tax purposes. The tax position is determined by looking at the end result, i.e. by looking to the substance of what has happened and ignoring the formal processes by which that end result was achieved. The precise method of taxing that result will depend upon the terms of the legislation sought to be applied.

SOME QUESTIONS ON THE NEW APPROACH

(1) Does the new approach only apply to complex pre-packaged tax avoidance schemes?

No particular level of complexity is required. The scheme in *Dawson's* case was described by one of the Law Lords as "simple and honest" and, furthermore, it was accepted that it was a scheme to *defer,* rather than to avoid, tax. Subject to what is said hereafter, therefore, any device designed to reduce or defer a person's liability to tax is potentially within the ambit of the new approach. The fact that it may be part of a wider commercial transaction will not take it outside that approach.

The essential feature, however, which has been emphasised in every case, including *Dawson's*, is that the transactions must be *"pre-ordained"*. It is not sufficient simply that one can identify a series of transactions: they must be pre-ordained, in the sense that there is some arrangement under which the various steps are to be carried through. The arrangement need not, however, be a contractual one.

Whether there is a pre-ordained series of transactions is a question of fact to be determined by the Tax Commissioners at the first stage of a tax appeal. Their decision can only be displaced on appeal to the higher courts if their finding is unsupported by evidence, so that no reasonable body of Commissioners could arrive at it, or if it is inconsistent with their other findings of fact.

To what extent the series of transactions must be planned in advance to become "pre-ordained" is at this stage unclear. Much will depend upon the evidence in each case. To take a simple example, however, in the U.K. there are no statutory provisions which specifically enable one company in a group of companies to set capital gains realised by it against a capital loss arising to another group company. The indirect method under which this has been achieved is as follows:

> Suppose A Ltd owns an asset on which there is an unrealised gain, and within the same chargeable gains group there is a company, B Ltd, which has losses sufficient to cover that gain; A Ltd finds an outside purchaser for the asset, X Ltd. The asset is transferred from A Ltd to B Ltd. That transfer does not give rise to any taxable gain or deductible loss because it is intra-group. B Ltd acquires the asset at A Ltd's cost (plus any indexation of that cost) and, accordingly, takes over A Ltd's unrealised gain. B Ltd then immediately contracts to sell the asset to X Ltd, realises the gain and sets it against its losses. There is, however, no business purpose involved in passing the asset between the group companies, beyond the avoidance of the liability to tax that would otherwise arise on the disposal of the asset. The new approach would suggest that the disposal is to be regarded as being by A Ltd to X Ltd and that the passage of the asset through B Ltd is pure conveyancing machinery, so denying the benefit of matching the gain and the loss in one company.

There are, however, a number of permutations upon the above example where the application of the *Dawson* case is less clear cut. Suppose for example, that:

(1) X Ltd has expressed interest in acquiring the asset but no terms or price have been agreed. Before any negotiations are undertaken, the asset is transferred to B Ltd which then negotiates the sale to X Ltd; or
(2) following the transfer to B Ltd, the sale to X Ltd falls through but a new purchaser, Y Ltd, is found and the asset is sold to that company; or
(3) A Ltd proposes to sell the asset but no steps to market it have been taken and no purchaser is in prospect. It transfers the asset to B Ltd which markets it and eventually sells it to Z Ltd.

In each case the only reason for transferring the asset to B Ltd is to avoid the tax on the ultimate disposal outside the group and, at the time of transfer, there is an intention to follow that transaction with another transaction of a specific type. In each case there may be a considerable time lag between the first transaction and the ultimate sale, during which time the market value of the asset may fluctuate. In each case it is considered that there is a series of transactions. However, in the case of (2) and (3), the *particular* transaction that is eventually effected, i.e. the sale to Y Ltd or Z Ltd, is not in prospect at the time that the first step is taken. Arguably, therefore, in those cases the series is not pre-ordained. In the case of (1), however, the position is less clear. To avoid the application of the new approach it is not sufficient simply that the sale to X Ltd *may* not take place. Are, however, the uncertainties of an eventual sale to the particular purchaser so great that the two steps in the series cannot be said to be pre-ordained? Given a sufficient degree of uncertainty it might be possible to satisfy the Tax Commissioners that the series of transactions was not pre-ordained.

(2) If there must be a pre-ordained series of transactions, does that mean that the effect of a single transaction cannot be negatived under the new approach even though it is entered into for tax avoidance reasons?

It is clear that the effect of a single transaction cannot be ignored for tax purposes in the same way as a transaction forming part of a series. Apart from anything else, a single transaction is unlikely to have the avoidance of tax as its *only* purpose; to deny any tax effect to such a transaction might in the circumstances be to pretend that the legal and financial positions of the parties have *not* altered, when they have and even though the new approach taxes by reference to the end result of the series of transactions. Yet to tax a *single* transaction according to its end result might be to pretend that it was something completely different to what it really was (see below).

These considerations, however, invite examination of the question as to what *is* a single transaction. A subscription of shares is a single transaction but, when coupled with an immediate disposal of the shares subscribed (as was the case under a scheme popular a few years ago), it may become a pre-ordained series which may be disregarded.

It seems from what was said in the *Dawson* case, however, that a deed of covenant, e.g. a covenant by a parent in favour of his student child to make regular payments to the child over a period of years, may be regarded as a single transaction even though it contains the elements of execution and then a series of payments under it. Arguably, a "bed and breakfast transaction" (under which assets (usually shares) are sold on one day and an equivalent amount is bought back shortly thereafter) comprises two single transactions rather than a pre-ordained series. Even if such transactions are a series, because they are effected in the open market (with A selling to B and then repurchasing from C, in circumstances in which B and C are unknown to each other and, furthermore, are unaware that A is indulging in a sale and purchase transaction), it may be that the series is not pre-ordained. Clearly, however, if all the parties are aware of the overall transaction and have (non-contractually) arranged in advance for each element to take place, the transaction would be disregarded for tax purposes. (The ability to undertake such transactions in a tax effective manner has in any event been restricted by legislation but they are still possible in certain cases.)

(3) Must tax avoidance be the only purpose of a step for it to be disregarded or can it merely be one of the purposes or one of the main purposes?

It seems that tax avoidance must be the only *purpose* of some of the steps in a series, but this is not inconsistent with the transaction having some enduring legal or business effect. Lord Brightman said in *Dawson's* case:

> there must be steps inserted which have no commercial (business) *purpose* apart from the avoidance of a liability to tax – not "no business *effect*".

Given that the ultimate commercial object the taxpayer has in mind is achieved through each of the series of transactions, each transaction must to some extent be executed with the purpose of achieving that objective. The important point seems to be whether the basic transaction undertaken, e.g. the disposal to the ultimate purchaser or the gift to the children, could have been carried through without the interposition of the particular steps whose purpose was merely to enable that basic transaction to be achieved in a tax efficient manner.

(4) If the new approach applies, at what stage of disposal does any tax liability arise?

In *Dawson's* case the transactions were effected over a short enough time span to make this question irrelevant. If, however, the transactions were started in one accounting period or tax year and ended in another, it might make a significant difference to the tax liability as to the period in which any tax liabilities arising from the transactions are to be taken into account. The taxpayer would also need to know in respect of which period the transactions in question should be reported.

By denying the application of the capital gains tax relieving provision in the *Dawson* case, effect was given to the actual disposal made by the shareholders as the first step in the series of transactions. Their tax liability was, however, computed by reference to the consideration ultimately received on the eventual disposal at the final step in the series. The new approach also determines the tax liabilities by reference to the *end* result of the series of transactions. Furthermore, although the series must be pre-ordained, it may be capable of being broken. Until it is actually completed, therefore, there can be no certainty that the new approach will apply.

It is considered that there is no one answer of universal application. In Lord Brightman's words in *Dawson:*

> The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.

On balance, the presumption may be that the tax consequences arise in the period in which the end result is achieved. This would not, however, preclude a different answer in the particular circumstances of an individual case.

(5) Does the relationship of the parties to the transactions have any effect on the application of the new approach to a scheme?

All that is required is that the scheme be pre-ordained. A scheme may, it is considered, be pre-ordained even though transactions within the scheme are between independent persons. The problem for the taxpayer will obviously be that at the time the scheme is considered by the Commissioners, the transactions will have gone ahead. Even though the taxpayer could not actually control events (e.g. as the majority shareholder of companies involved in the Scheme), those events have in fact happened.

The existence of a controlling individual or individuals, or, as one judge has put it, a "single mastermind", will, however, be a strong factor in linking transactions in a series and ensuring that they are regarded as pre-ordained, making it more difficult to satisfy the Inland Revenue and the Tax Commissioners on this aspect.

(6) If a transaction can be done in two ways, each having a different tax result, and the way chosen is the one that gives rise to a smaller tax liability, can the actual transaction be ignored, the other way substituted and the larger tax liability imposed?

The tax liability is to be determined by reference to the end result of the transactions, and the court is entitled to *disregard* any step in the pre-ordained series. It is considered that the new approach enables the tax position to be determined by reference to the substance of the basic transaction (e.g. a disposal from A to C) rather than its form (e.g. a disposal by A to B and by B to C) but, provided all the transactions actually entered into are genuine, this does not enable the Inland Revenue either:

(a) to substitute a different underlying transaction; or
(b) to confer upon genuine transactions within the series a different character; or
(c) to deem new transactions to have been included in the series.

If an agreement or transaction is found to have a particular legal nature, one still cannot ignore the form of that agreement or transaction and treat it as something else merely because in substance it achieves the same economic result. Thus, in the *Duke of Westminster's* case, the Duke used a deed of covenant to put money into his employee's hands and the employees chose not to claim from the Duke their wages under their contracts of employment. Having accepted that the document in question was a genuine deed of covenant, the Inland Revenue could not argue that payments under it had the character of wages merely because, in substance, they achieved the same financial result as payments of wages would have done.

Thus, if D and E enter into cross options (to sell and to buy) in respect of an asset and, as a matter of legal analysis, they are genuine options, it is considered that the new approach does not enable the Inland Revenue to say that they amount, in substance, to an unconditional contract to dispose of the asset.

Similarly, if A grants to B a 999 year lease of land, the new approach does not enable the Inland Revenue to say that A has in substance sold his freehold interest in the property. However, if A were subsequently to transfer his remaining freehold reversion to B and B merged the lease in the freehold reversion, that could be regarded as a sale of the freehold if both transactions were part of the same pre-ordained series of transactions and the grant of the lease were merely to avoid tax on the sale of the freehold.

(7) Does the new approach, by enabling the courts to disregard transactions, allow them to impose tax where none would otherwise arise?

Dawson's case illustrates that, by disregarding a transaction within a pre-ordained series, a relief from tax is denied and a charge to tax consequently arises. The transaction, the result of which would have enabled the shareholders to deny that they had disposed of their shares, was ignored and that left them with the usual tax consequences of having made a disposal. The new approach also enables the Courts to ignore completely the effect of the transactions for tax purposes where, as in *Ramsay* and *Burmah,* the schemes are circular so that one element of it cancels out another: if the end result is zero, so the tax effect is zero.

Nevertheless, it is considered that the new approach does not enable the Courts to disregard a transaction for the purposes of one aspect of the relevant legislation but to have regard to the *same* transaction for other purposes of the *same* legislation: they cannot pick and choose which of the relevant statutory provisions are or are not to apply. Similarly, they cannot alter the basic nature of the transaction so as to bring it within the charge to tax (see (6) above).

(8) Does the new approach enable the Inland Revenue to recompute the tax charge by reference to amounts other than those received by the parties as part of the transaction?

The tax position is determined by reference to the end result. It is considered that this does not enable the Inland Revenue to recompute liabilities other than by the overall financial results of the transactions.

It appears that, in *Dawson,* the shareholders were taxed by reference to the consideration received by the intermediate company from the ultimate purchaser, even though they did not receive beneficially the cash with which to pay the tax. Thus, it appears that, in a group context, if an asset passes intra-group from A Ltd to B Ltd and then to an outside purchaser, X Ltd, in circumstances in which the new approach applies, A Ltd will be assessed by reference to the consideration received by B Ltd irrespective of the consideration deemed to be given by B Ltd under the relevant group legislation or the actual consideration it gives. Variations in the market value of the asset after the initial step would still seem to be taxed on the original owner, assuming that the steps are in such circumstances pre-ordained.

If, however, a company intending to sell a subsidiary extracts a dividend from it prior to sale, or engages in other transactions so as to reduce the value of its shares (and thus the eventual consideration paid), it is considered that the new approach cannot increase the sale proceeds by the amount of the dividend or other amount taken out. The dividend, as a genuine transaction, cannot be given a new character as sale proceeds.

(9) If particular tax liabilities or consequences would arise in respect of those transactions in the pre-ordained scheme which are to be disregarded as being inserted for tax avoidance reasons, can those be avoided by applying the new approach?

The essence of the new approach is that each transaction is real, and is not a sham. Thus, if a particular transaction in the series gives rise to a tax charge which stands as a liability in its own right, that liability, it is considered, cannot be avoided. The most obvious example is any liability to stamp duty or capital duty or to VAT on any of the transactions involved. If the tax consequence in question is one which is inherent in the scheme itself, the position is clearly more difficult. Thus, in the case of the group capital loss scheme previously mentioned, could the Inland Revenue on the one hand apply the new approach to treat A Ltd as disposing of the asset to X Ltd and, on the other hand, reduce B Ltd's losses because it also disposed of the asset at a gain? If B Ltd were subsequently denied relief for the losses, could it argue that a *genuine* transaction into which it entered did not have certain tax consequences because, *in relation to another taxpayer,* the transactions of which it was a part were to be disregarded? The transaction may clearly have some real consequences for such an intermediate taxpayer: it receives the consideration for the ultimate sale and may deal with that money as it pleases.

While no clear answer to this question has been provided by the Courts, it is considered that, for tax purposes, once the pre-ordained series of transactions has been ascertained and the new approach applied to the end result, the individual elements that go to make up that end result are ignored in relation to all taxpayers concerned *for the purposes of the particular tax provisions in question,* and not merely in relation to that taxpayer whose tax liability the Inland Revenue are seeking to alter in consequence. If, however, there are other, incidental consequences of the transactions, for example, if income arose from the asset while in B Ltd's hands, the usual tax consequences of that would flow, as they would, for example, from the reinvestment of the sale proceeds by the intermediate company in *Dawson's* case.

(10) If as part of the series of transactions new assets, rights or liabilities are acquired or undertaken by parties to the transactions, does the application of the new approach to the scheme affect the tax treatment of those assets, rights or liabilities in the future?

In the *Dawson* case the shareholders ('D') at the end of the scheme owned shares in the intermediate company ('G Ltd') and G Ltd had the cash arising on the sale. To ensure that D was not taxed on the disposal of G Ltd's shares by reference to the same gain realised on G Ltd's sale of the original shares the House of Lords decided that G Ltd's shares were acquired by D for a consideration equal to what was paid for them, i.e. the value, at the time of the transaction, of the shares in the companies which were ultimately sold by G Ltd. Had the deferral scheme worked, D would have acquired the G Ltd shares at the original cost of the shares given in exchange. Insofar as this aspect of the new approach has any principle attached to it, it seems that the end result proposed must be such as negates the tax advantage but does not otherwise give rise to a tax disadvantage.

It may not, however, be possible to return the taxpayer to his original tax or financial position. Suppose, instead of using an intermediate company and a share exchange, the asset had been placed into a settlement. The gain could normally be deferred under existing legislation on the transfer into the settlement. The trustees might then dispose of the asset and realise the gain themselves. If there was a genuine purpose to the creation of the settlement as, for example, to provide for the settlor's children, that transfer might not be capable of being disregarded under the new approach. The disposal of the asset into the settlement might not, however, be a necessary step in achieving the purpose of providing for his children. The new approach might in the circumstances apply to disregard the gift into settlement (but not the creation of the settlement), to tax the settlor as if he had disposed of the asset to the ultimate purchaser and to treat him as having settled the proceeds (which he then might be unable to recover to meet the tax liability). Inevitably, if that analysis applied the taxpayer would be in a worse position.

(11) Does the new approach enable particular circumstances or a change in circumstances to be disregarded or only a transaction?

If a person ceases to be resident and ordinarily resident in the U.K. and realises assets before returning to the U.K., can the new approach ignore the change in residence and seek to tax him in respect of the disposals? If a group company becomes resident in the U.K. and seeks to group relieve losses or to pay a group dividend (both of which can only be done by resident companies), can the Inland Revenue deny relief or tax the dividend as foreign-source income by saying that the company's change of residence is to be disregarded?

On the basis that a genuine state of affairs exists, e.g. the company's central management and control really has been transferred into the U.K., it is considered that the new approach does not enable a new set of facts or circumstances to be substituted. A transaction can be disregarded but it cannot be regarded either as having a different character (see (6) above) or as being the same transaction (e.g. payment of a dividend) but effected under different circumstances.

(12) Does the new approach only apply to capital gains tax avoidance schemes or are all other tax-avoidance schemes satisfying the relevant criteria affected?

There is nothing in the various cases which limits the new approach to capital gains tax avoidance schemes. The references in Lord Wilberforce's judgment in *Ramsay* to the previous decision on an income tax avoidance scheme (the "reverse annuity" scheme) in *CIR* v *Plummer* (1979) STC 793 confirms this view. In *Cairns* v. *MacDiarmid* [1983] STC 226, the new approach was also applied to an income tax-saving device. Essentially, the new approach is of quite general application: it is the way in which U.K. tax law interacts with other branches of U.K. law where a pre-ordained series of transactions satisfying the relevant criteria can be found. As such there seems no reason why it should not apply in any tax context.

There may, however, be one area, stamp duty, where the new approach is limited. Stamp duty is a tax on documents rather than a tax on transactions. Even if the Inland Revenue seeks to use the new approach to disregard elements of a stamp duty saving scheme, it must still be able to produce a stampable document and show that the document is stampable not according to the particular transaction it covers and the consideration attributable to it, but by reference to the overall transaction and the consideration given under the various stages of the scheme.

(13) Is the new approach of compulsory application?

If the Inland Revenue chose to argue the new approach and the court finds that the relevant criteria are present, it must give effect to the new approach.. How effect is given in any particular case is, of course, another matter. If, however, the Inland Revenue approaches the matter on a step by step basis, analysing each transaction and its tax effects, it is not clear that the court is bound to take the initiative and apply the new approach. Thus, if the Inland Revenue decides not to apply the new approach to intra-group transfers designed to utilise group capital losses (rather than capital losses brought in from outside the group), it seems that such transfers are perfectly effective for tax purposes. This was the Inland Revenue's approach before *Dawson* and this will presumably continue, although it is to be hoped that specific confirmation will be given.

Assuming that he wished to do so, it is not clear that the taxpayer can himself invoke the new approach. He would in effect be arguing that genuine transactions undertaken by him and the other participants in the scheme were to be disregarded. While this may be unlikely, the need to argue the new approach might arise if the scheme went disastrously wrong and steps in it gave rise to actual liabilities in excess of that which would have arisen had a more straightforward transaction been undertaken.

(14) Can the new approach be used against the Inland Revenue?

As one criterion is the purpose to avoid a tax liability, it seems that the new approach cannot be used directly against the Inland Revenue as a means of countering arguments by them based on a wholly "artificial" (although technically correct) interpretation of the tax legislation or anomalies in that legislation. However, insofar as the new approach is indicative of a general approach to the interpretation of tax legislation by the courts, there is no reason to believe that the Inland Revenue will get a better treatment for some of its more technical arguments which appear to be contrary to the spirit of the legislation.

CONCLUSION

Much is yet to be revealed about the new approach; far more has to be considered than has been mentioned in this article, which can be no more than a first reaction to the *Dawson* decision.

However, three points can be highlighted immediately:

(1) The criteria which appear to determine the application of the new approach are matters of fact. Transactions must be properly documented and evidence must be forthcoming as to their purpose and the manner of their execution. Effective presentation of the evidence on appeal before the Tax Commissioners is crucial.

(2) Advance tax planning is the key for the future. By planning ahead gains and losses will arise in the most tax efficient manner and reliefs and exemptions will be available to the right persons. Manoeuvres over a short time span which may be vulnerable to the new approaches will be avoided.

(3) Make the most of those tax shelters which have a U.K. Government seal of approval: Business Expansion Scheme, industrial buildings, enterprise zones and freeports; make effective use of reliefs, such as group and loss reliefs, approved pension schemes and life assurance arrangements.

With foresight a man may still organise his affairs so as to minimise his liability to tax.

In next issues:

U.S.A.: Foreign tax credit

O.E.C.D.: The taxation of income derived from the leasing of containers

Australian resources rent tax
– by *D.C. Orrock*

E.E.C.: The future financing of the community
– A new Commission proposal –

The tax system of Tuvalu
– by *Eugen Jehle*

India: Budget 1984-85
– A summary by *Kailash C. Khanna*

A summary of Singapore's 1984 Budget
– by *Lee Fook Hong*

WORLD-WIDE COMBINED REPORTING

RECENT DEVELOPMENTS

By Leonard W. Rothschild, Jr.

In an earlier article,[1] I examined the unitary tax concept and its effect on foreign-based multinational companies, and described certain proposed Federal and state legislation. I concluded in that article that no further Federal or state legislative action would occur until after the U.S. Supreme Court decided **Container Corporation of America** *and* **Caterpillar Tractor Co.**

FEDERAL COURT DECISIONS

Container Corporation of America

On 27 June 1983 the Supreme Court upheld the validity of California's unitary tax method in *Container Corporation of America v. Franchise Tax Board (Container).*[2] This case is significant in that it upheld the use of the world-wide combined reporting system including the foreign subsidiaries of a U.S. corporation.

Container Corporation, a subsidiary of Mobil, controlled 20 foreign subsidiaries in Latin America and Europe. In calculating its California tax liability for the years 1963-65, Container Corporation excluded the income and apportionment factors of its foreign subsidiaries. The California Franchise Tax Board (FTB) believed that the foreign subsidiaries were part of Container Corporation's unitary business and assessed additional taxes.

Container Corporation advanced three arguments, (1) the foreign subsidiaries were not part of the unitary business, (2) even if the foreign subsidiaries were found to be part of the unitary business, certain differences among national economics resulted in an unreasonable allocation of income to California, and (3) the application of the unitary concept to foreign subsidiaries was unconstitutional under the Foreign Commerce Clause of the U.S. Constitution.

With respect to the first argument, the Supreme Court stated that it *"will, if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a 'unitary business'"*. Nevertheless, after reviewing the underlying facts the Supreme Court concluded that the foreign subsidiaries were part of Container Corporation's unitary business, noting, in particular, that half of the subsidiaries' long-term debt was either held by or guaranteed by the parent and that the parent exercised a significant managerial role over its subsidiaries.

The Supreme Court also held for the FTB with respect to the second argument. Container Corporation attempted to show the unreasonable allocation of income to California through the presentation of its separate accounting records for the subsidiaries. The Supreme Court stated that separate accounting *"may fail to account for contributions to income resulting from functional integration, centralization of management and economies of scale"*, the exact weakness which the unitary method and formula apportionment method was meant to correct. Noting that even though the three-factor formula used by California was imperfect, *"we have seen no evidence demonstrating that the margin of error . . . is greater than the margin of error . . . "* inherent in the separate accounting method.

In considering the third argument, the Supreme Court indicated the need to consider the risk of multiple taxation and the possibility that a state will *"impair Federal uniformity in an area where Federal uniformity is essential"*. In holding for the FTB, the Supreme Court noted, however, that California's tax system did not "inevitably" lead to double taxation and that the tax was nevertheless imposed on a domestic corporation. The Supreme Court did recognize that their response may have been different if Container Corporation had not been a domestic corporation, and stated: *"We have no need to address in this opinion the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries"*. Thus, although this decision concludes that it is proper for states to use the unitary method on a world-wide basis for domestic corporations, a decision has not yet been made by the Supreme Court with respect to the validity of this method to foreign-controlled U.S. corpo-

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1. 37 Bulletin for International Fiscal Documentation 2 (1983) at 59-64. Hereinafter referred to as "BIFD".
2. Container Corporation of America v. Franchise Tax Board, 103 S.Ct. 2933 (27 June 1983). Certiorari denied 12 October 1983. See also Gary M. Peterson, "The unitary tax issue – a review of the Container Corporation case and its effect on foreign-based multinationals." *U.S.–Japan Business News,* July 18, 1983, p. 5.

rations. (*Caterpillar Tractor Co. v. Illinois Department of Revenue*[3] was dismissed by the Supreme Court on 6 July 1983 for want of substantial federal question).

Shell Petroleum N.V., and Alcan Aluminium Ltd.
After the 27 June 1983 *Container* decision, the Supreme Court had two additional opportunities to hear unitary tax cases involving foreign parent companies. In both instances the Supreme Court denied petitions for review, and the decisions of the lower courts became final. The lower courts held on procedural grounds, in both cases, that the foreign parent companies must initially pursue their actions in state courts, rather than directly in the Federal court system. Neither of the lower court decisions decided the unitary tax issue on the merits, but only addressed certain procedural questions.

In *Shell Petroleum N.V. v. Graves, et al.*,[4] the plaintiff (SPNV) was a Netherlands company. During 1967 to 1976 SPNV held 69% of the stock of Shell Oil, and 100% of the stock of Scallop Nuclear (Scallop). Shell Oil and Scallop were both incorporated in Delaware and conducted business in California. At the time this action was brought the FTB was in the process of auditing Shell Oil and Scallop, and had demanded information concerning the world-wide operations of SPNV from Shell Oil and Scallop. SPNV alleged that the FTB would make a determination that the two California taxpayers were part of a unitary business consisting of all companies world-wide in which SPNV was the majority owner. According to SPNV, such a determination would produce a gross disproportion between the income attributed to the California activities of Shell Oil and Scallop and the income actually earned.

The appeals court ruled on two issues: whether SPNV had standing to sue in Federal Court, and whether the controversy was ripe for decision. With respect to the standing issue SPNV alleged, as a shareholder, that it had standing through the Treaty of Friendship, Commerce and Navigation between the United States and the Netherlands.[5] However, after reviewing the pertinent portion of the Treaty, the court concluded that the Treaty merely placed SPNV in the same position as a domestic corporation. Under applicable domestic law, a domestic corporation holding a majority interest in Shell Oil or Scallop would not have standing to sue in this case, as the injury complained of was not direct or individual to the parent corporation.

The appeals court further held that Shell Oil and Scallop have plain, speedy, and efficient administrative and state court remedies, and therefore the controversy can not yet be considered ripe for decision. In order for the controversy to be considered ripe in a Federal Court, the taxpayer must first protest the FTB assessment, then appeal an adverse decision to the State Board of Equalization, and finally litigate the case in the California court system.

In *Alcan Aluminium Ltd. v. Franchise Tax Board*,[6] the taxpayer (Alcan) was a Canadian corporation. The FTB levied a tax based on the unitary method on Alcan's wholly owned subsidiary, Alcan Aluminium Corporation (Alcancorp). The tax was computed based in part on Alcan's subsidiaries that were foreign corporations having no business or contacts in the United States. Alcan contended that the world-wide application of unitary taxation was unconstitutional, especially when the domestic subsidiary dealt with the foreign parent corporation and foreign subsidiaries at arm's length, if at all. Alcan demonstrated that in years when its U.S. operations showed a loss and its foreign operations showed profits, it nevertheless paid California income tax. Alcancorp paid the California tax as assessed and sued for a refund in state court. In the Federal action, Alcan, the foreign parent corporation, raised constitutional claims and sought declaratory and injunctive relief.

The FTB asked the Federal court to dismiss the case on the grounds that the court lacked subject matter jurisdiction, since there was an identical action brought by Alcancorp, Alcan's subsidiary, in state court. Alcan argued that its domestic subsidiary was not engaged in foreign commerce and, therefore, had no standing in state court to raise the constitutional issues of multiple taxation of the instrumentalities of foreign commerce and interference with the exclusive Federal jurisdiction over foreign commerce. The court, in ruling for Alcan, relied on *Capitol Industries – EMI, Inc. v. Bennett*[7] by holding that although the claims of Alcan and Alcancorp were substantially the same, their interests were not necessarily identical. However, the court decided to stay the action pending a disposition of the Alcancorp case in state court, or in other cases before the California or U.S. Supreme Courts. Therefore, Alcan was left in essentially the same position as Shell Petroleum N.V.: that it must first pursue its action in state court.

In February 1983 the U.S. Supreme Court in denying a petition for review in *EMI, Ltd. v. Bennett et al.*[8] took the unusual step of explaining its position. The Supreme Court stated: *"Court dismisses, for lack of subject matter jurisdiction, United Kingdom company's complaint challenging tax deficiency assessed against its subsidiary by California; neither United Kingdom corporation's status as controlling shareholder of its U.S. subsidiary nor U.S.-U.K. Income Tax Convention confers standing on U.K. corporation to challenge California's assessment of tax against its U.S. subsidiary."*

It appears that the U.S. Supreme Court will not decide to hear a foreign parent unitary tax case until such time as an appropriate case has first been adjudicated by a state court. This means that a corporation which believes that the unitary tax method is unconstitutional when applied to a foreign parent corporation must be prepared not only to argue the constitutional issues, but also to demonstrate, based on the particular facts, that the unitary method results in income attributed to a state which is

3. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co. and Illinois Department of Revenue, No. 81-349 dismissed 6 July 1983.
4. Shell Petroleum N.V. v. Graves, et al., 709 F. 2d 593 (9th Cir. 1983); No. 82-4535; Certiorari denied 5 December 1983.
5. Treaty of Friendship, Commerce and Navigation, 27 March 1956, United States-Netherlands, 8 U.S.T. 2043, T.I.A.S. No. 3942.
6. Alcan Aluminium Ltd. v. Franchise Tax Board, 539 F. Supp. 512 (1982); No. 82-7236, 2nd Cir. affirmed in an unpublished decision on 17 June 1983; Certiorari denied 9 January 1984.
7. Capitol Industries – EMI, Inc. v. Bennett, 681 F. 2d 1107 (9th Cir. 1982).
8. EMI, Ltd. v. Bennett, et al., No. 82-903 at 51 U.S. Law Week 3608 (15 February 1983).

"out of all appropriate proportions to the business transacted in the state".[9]

This means that a substantial effort will be required to make the unitary tax computations *before* the U.S. Supreme Court will be inclined to accept a case for review. Given the time necessary to exhaust all administrative and state court appeals, it will probably be at least 3 or 4 years before the U.S. Supreme Court will have an opportunity to review a foreign parent case.

If the U.S. Supreme Court ultimately decides to rule on the constitutionality of the unitary tax as applied to a foreign parent, it is possible that the unitary tax will be held unconstitutional under the rationale of *Japan Line Ltd. v. County of Los Angeles.*[10] In *Japan Line* the Supreme Court stated that if a state tax *"impair(s) federal uniformity in an area where federal uniformity is essential"*, such a tax violates the Commerce Clause, as this prevents the United States from *"speaking with one voice when regulating commercial relations with foreign governments"*.

WORLDWIDE UNITARY TAXATION WORKING GROUP

Soon after the 27 June 1983 decision in *Container,* a petition for rehearing was filed with the U.S. Supreme Court. Since the Supreme Court was in recess, and not scheduled to reconvene until 3 October 1983, for three months the Reagan Administration was under intense pressure from foreign governments to request that the Supreme Court reconsider its decision. The Reagan Administration asked the Cabinet Council on Economic Affairs to study this issue and to make a recommendation. The advice of the Cabinet Council was that the Administration should authorize the Solicitor General to file a brief with the Supreme Court in support of a rehearing, and should support legislative measures that would restrict the unitary method of taxation to profits earned within the United States. Most observers believed that without the Administration's strong support for a rehearing, the Supreme Court would choose not to rehear the case. President Reagan rejected the recommendation of the Cabinet Council, and the Supreme Court denied the petition for rehearing on 12 October 1983. The Reagan Administration then appointed a working group to recommend a solution to the problems posed by state taxation under the world-wide unitary method.

The Worldwide Unitary Taxation Working Group (Working Group) was formed on 22 September 1983. The Working Group consists of representatives from the Federal government, state governments, and the business community. The business representatives include the Chairman or President of the following companies: International Business Machines, Ford Motor Company, Exxon Corporation, Pfizer, Inc., Caterpillar Tractor Company, Safeway Stores, Inc., and BATUS, Inc. The Working Group was formed to "*. . . advise and assist in the development of a policy dealing with the complex issues involved in the states' use of the worldwide unitary method of taxation. It is in the public interest that this tax issue affecting our individual states and our trading partners be resolved in a fair and workable manner by a cooperative effort of the affected parties"*.[11]

The Working Group and its appointed task force began hearings on 2 November 1983, meeting in several days of open and closed meetings. From all indications it appears that the Working Group has made a diligent effort to understand the problems and concerns of foreign-based multinational companies. On 5 December 1983 the Working Group narrowed the scope of its investigation into states' use of the world-wide unitary approach to taxing corporate income, by generally ruling out the Administration's consideration of Federal legislation to override state tax laws. Instead, the Working Group directed its staff task force to develop a series of options by 24 February 1984, that would involve persuading states to voluntarily adopt a method for taxing domestic and foreign-based multinational corporations that would be less objectionable to the corporations and to the United States trading partners than the world-wide unitary method.[12] On 16 February 1984, Treasury Secretary Donald T. Regan announced postponement of the 24 February 1984 deadline until late March.[13]

If Federal legislation is not supported by the Working Group, it is unlikely that foreign-based multinational corporations will gain significant relief from the current method of world-wide combined reporting. It has been suggested that states may be receptive to modifying the world-wide combined reporting method if the Working Group is successful in allowing the Internal Revenue Service to share more tax information with the states. It is hoped that in exchange for receiving more complete information, the states will agree to limit the unitary tax approach to a "water's edge" concept, by which only income earned in the United States would be subject to state tax. However, the states will probably insist on retaining the ability to tax profits earned overseas when necessary, in their opinion, to properly reflect the true taxable income of the United States business operations. While it is possible that certain states may unilaterally modify their approach toward world-wide combined reporting, without Federal legislation it is not reasonable to expect that voluntary efforts by a few states will alleviate the plight of most foreign-based multinational corporations.

PROPOSED LEGISLATION

Federal

Proposed Federal legislation was discussed at length in my earlier article.[14] Senator Mathias has reintroduced his bill which would restrict the states' ability to impose their taxes on income of multistate corporate businesses. The new bill is S.1225, which is the same one previously known as S.655 in the last Congress. Representative

9. Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931).
10. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).
11. Letter from John E. Chapoton, Assistant Secretary (Tax Policy) of the Treasury, dated 28 October 1983.
12. 37 BIFD 2 (1983) at 61-62.
13. BNA Daily Tax Report, 17 February 1984, p. G-8.
14. BNA Daily Tax Report, 6 December 1983, p. G-2.

Conable's former bill, H.R.1983, has also been reintroduced as H.R.2918 in the current Congress.

No hearings have been scheduled on these bills, as the Congress has been awaiting the report of the Working Group. It is very doubtful that this proposed Federal legislation will move forward at all this year.

State

Many observers predicted that after the U.S. Supreme Court upheld the unitary tax concept in *Container,* several states would adopt the world-wide unitary tax method, and that states already using the "water's edge" unitary tax method would expand that method to the world-wide combined reporting method.

The first state which adopted a new world-wide unitary tax after the *Container* decision was Florida. The Florida bill, which was signed on 13 July 1983, is estimated to raise $95,000,000 annually, essentially through the taxation of foreign-source income that had previously been exempt from Florida's corporate income tax. The apportionment formula used by Florida is virtually identical to the California formula. It should be noted that Florida is presently considering repealing its unitary tax, as several companies have threatened to move businesses from Florida to non-unitary tax states.

A number of other states are examining the imposition of a new unitary tax, such as the one just introduced in Florida. On the other hand, several states which believe the unitary tax is a disincentive for investment have pledged not to enact a world-wide unitary tax. A delegation of Japanese businesses which surveyed state governments received pledges from the following states not to enact a global unitary tax: Alabama, Hawaii, Kansas, Mississippi, New York, North Carolina, and Virginia.[15]

CONCLUSION

The *Container* decision was a serious set-back for domestic parent corporations doing business in states which use the world-wide combined reporting method. Although the Supreme Court did not rule in the situation involving a foreign parent corporation, the failure of the Supreme Court to rule results in a situation where many states will continue to aggressively pursue world-wide combined reporting by foreign parent corporations. The U.S. Supreme Court will eventually decide a unitary tax case involving a foreign parent corporation, but such a decision will probably not be made for 3 or 4 years. It is far from certain how the Supreme Court will rule on the unitary tax as applied to a foreign parent corporation, but there appears to be sufficient legal precedent to distinguish the decision in *Container* from a similar situation involving a foreign parent.

The Working Group is now formulating suggestions on how to apply the unitary tax method to a U.S. subsidiary owned by a foreign parent. The Working Group is not likely to favor a legislative solution to the problem, but rather a less drastic approach. For example, the Working Group may propose that the states restrict in some manner the application of the world-wide unitary tax, providing that the states are supplied sufficient information to properly compute the state tax using an arm's length pricing approach. However, as a practical matter, it appears that without Federal legislation to back up the Working Group's recommendations, it is not likely that many states will fully adopt the recommendations.

The most workable solution is the enactment of Federal legislation. Federal legislation will ensure equal treatment for all U.S. subsidiaries owned by foreign-based parent companies, irrespective of where they are doing business in the United States. Although there are some technical defects in the current proposed Federal legislation, S.1225 and H.R.2918 represent a reasonable approach to the unitary tax problem, and enactment of this legislation would be welcome. Unfortunately, there is no feeling of urgency in Congress to move this legislation forward, and it is not likely that Federal legislation will be passed in the near future.

For those foreign-based companies contemplating doing business in the United States for the first time, it may be important to locate in a jurisdiction which does not use the world-wide combined reporting method. For companies already located in a state using the world-wide combined reporting method, consideration should be given to making future investments in other states with a more favorable attitude toward foreign investment. If it can be demonstrated that a particular state is losing foreign investment to other states because of its taxing system, sooner or later that state will be forced by economic conditions to change its laws. It appears that certain states are beginning to recognize this basic economic principle, and it is hoped that eventually most states will unilaterally abandon world-wide combined reporting.

15. BNA Daily Tax Report, 13 February 1984, p. G-4.

United Kingdom Versus Unitary Taxation

Statement of the United Kingdom before the United States Treasury Working Group on Worldwide Unitary Taxation*

Summary of principal points

A. Her Majesty's Government is opposed to the application of the unitary method of state taxation on a worldwide reporting basis.

B. The worldwide unitary method of state taxation is contrary to well established international principles and practice of taxation, and imposes unreasonable tax and administrative burdens on multinational corporate groups doing business throughout the world.

C. Unitary taxation is already damaging commercial and economic relations between the US and the UK and other countries. If it continues, the damage to international trading relations will become more serious. If unitary taxation spreads, the scale of the worldwide damage will be further increased.

D. In particular for UK companies unitary tax imposes significant additional burdens on both the companies and their shareholders. First it produces anomalous tax liabilities, which may be considerately larger than those calculated on the internationally-accepted arm's length basis. Second the requirements of the method involve additional compliance costs. In addition the uncertainty generated by the unitary method has disruptive effects on UK corporations' business activities and industrial investment.

E. As long as the worldwide unitary method persists, it will be impossible to achieve the essential economic objectives of providing a consistent and coherent tax framework for international trade and investment. Moreover, the damage to international trade and investment would be greatly increased if foreign Governments responded by imposing retaliatory measures or introducing unitary systems of their own.

I. INTRODUCTION

1. Almost two years ago, the United States Government advised the Supreme Court in its brief in the *Chicago Bridge & Iron Co.* case, that "the imposition of [a state tax] on the apportioned combined worldwide business income of a unitary group of related corporations impairs federal uniformity in an area where such uniformity is essential". That explicit pronouncement of United States policy is equally appropriate for today. Indeed, since that brief was filed, the threat to international business relations posed by the worldwide unitary method of state taxation has assumed even greater magnitude. At present 11 states employ the worldwide combined reporting system, namely Florida, California, Massachusetts, Oregon, Alaska, Idaho, Colorado, Montana, New Mexico, North Dakota and Utah. Approximately 70 per cent of the direct foreign investment in the United States comes from Western Europe. Hence, the burden of the unitary worldwide combined reporting system falls particularly heavily on European based corporations.

2. It is therefore hardly surprising that the unitary tax issue has been the subject of repeated diplomatic protests from other governments since 1979. On August 1, 1983, the 10 governments of the European Community delivered a diplomatic note to the United States Government renewing their objections to the international application of the unitary tax. Similar objections were expressed by the Japanese Government on August 11, the Netherlands Government on August 17, and the Canadian Government on August 23. Earlier protests against unitary taxation by these governments have been well publicised.

3. The United Kingdom has an interest even stronger than that of other Governments since the United Kingdom direct investment in the United States is greater than that of any other country. By 1982 the cumulative total of United Kingdom investment in the United States was $23.334 billion which accounted for 23% of the foreign direct investment in the United States. Any measure which inhibits investment by British business in the United States is clearly to the detriment of both countries. Her Majesty's Government believes that unitary taxation already has a damaging effect on the business relations between the two countries and that the damage will become very serious if the issue is not speedily resolved.

4. The unitary method of taxation is wholly contrary to the agreed international method of attributing the profits of multi-national enterprises between the countries in which they operate. This is the arm's-length method which seeks to ensure that profits of such enterprises are allocated in such a manner that each country is able to claim tax on the profits – and no more and no less than the profits – actually earned in that country. If all countries use the same arm's-length basis in determining the profits, then double taxation should be avoided through the international net-work of double taxation agreements.

5. Unitary taxation is incompatible with this internationally agreed method. It uses a formula to determine what sum shall be charged and, as practised in the States, it may include profits brought into charge elsewhere on the arm's-length basis. If unitary taxation were practised worldwide and every national state could use an identical formula for determining its share of the profits of a multinational enterprise then agreement might be reached internationally on such a basis which would eliminate double taxation. It is, however, the case that over the last 40 years or more the international community has devised and refined the arm's-length method for international use. It is in this context of worldwide agreement about the method of attributing profits to multinational companies that the use of a different method by some states of the United States causes a distortion which makes it internationally unacceptable.

6. It is for these reasons that Her Majesty's Government has consistently urged that action be taken to prevent the application of unitary taxation to United Kingdom businesses. It sought to do so when negotiating the current United Kingdom/United States Double Taxation Agreement: but when in 1979, the United States Senate ratified the Treaty it attached a reservation against this provision in Article 9 (4). That Article in its original form would have prevented the United States Government and the individual states from applying the unitary method to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form, the Article applied only for purposes of the United States Federal tax, which does not employ the unitary method. At the time the United Kingdom, with the approval of Parliament, ratified the amended Treaty and accepted the Senate reservation against Article 9 (4), Her Majesty's Government was given to understand that the Government of the United States would use its best endeavours to eliminate the application of the unitary method of taxation on a worldwide basis. Nevertheless, since then more states have adopted the worldwide unitary approach.

7. Attempts have been made concurrently to secure a solution through the United States courts without success. Last June the United States Supreme Court ruled in *Container Corporation* v *Franchise Tax Board,* that the California worldwide unitary tax method did not violate the Foreign Commerce Clause of the United States Constitution as applied to a United States parent corporation and its foreign subsidiaries. In so holding, the Court specifically reserved the question of the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries.

8. In Her Majesty's Government view, the Court's decision in *Container Corporation* was an unfortunate setback that derived, in large measure, from the confusion caused by the failure of the United States Government to reaffirm the position taken in its original brief in the *Chicago Bridge* case, to which we have referred. In considering whether the California tax impaired federal uniformity and the conduct of United States foreign relations, the Court observed that the federal government's failure to file an amicus brief in the *Container* case suggested that "the foreign policy of the United States is not seriously threatened by California's decision to apply the unitary business concept and formula apportionment . . ." Hence, Her Majesty's Government believes that the outcome of the Court's sharply divided (5-3) decision could well have been different had the federal government clearly restated what all parties originally understood to be its position.

9. Moreover, the likelihood of an early resolution of the applicability of the unitary method to the foreign parent corporation case reserved by the Supreme Court is very much in doubt. Attempts are being made to have the matter heard but two courts of appeal have dismissed suits by foreign corporations against the California Franchise Tax Board on the ground that those foreign entities lack "standing" to contest the tax assessments that are nominally addressed to their domestic subsidiaries. On the other hand, as domestic corporations, the subsidiaries cannot invoke the treaty provisions that are at the heart of the claim that the unitary method impairs the conduct of foreign relations. Hence, these court rulings render rights conferred by treaties unenforceable by the very entities those provisions were negotiated to protect companies of one treaty part engaged in this way in the territory of the other treaty party.

10. The denial of standing to raise claims under the United States Constitution will leave foreign parent companies which in fact bear the economic burden of double taxation caused by the unitary method unable to challenge the lawfulness of that burden. This may not be "taxation without representation" as it is usually understood. But it does amount to taxation without the right to be heard, in that a levy whose constitutionality is at issue cannot be challenged by a party directly affected by it. Reciprocally narrow rulings by foreign courts would weaken the ability of the United States companies to obtain judicial protection for their investments abroad.

11. In sum, the failure of both the treaty making process and federal litigation to resolve the validity of the worldwide unitary method makes it imperative that a comprehensive solution be reached as soon as practicable. It is Her Majesty's Government's view that this method is incompatible with the internationally accepted regime for taxing the profits of multinational enterprises.

II. CRITERIA FOR JUDGING A TAX SYSTEM

12. Any tax system should be judged on whether it is capable of being administered equitably, produces certainty and efficiency, and whether it is capable of simple operation. The effects of applying unitary tax on a worldwide basis are both *inequitable* and *uncertain.* Moreover it is *far from simple* for the companies concerned, since it requires a restatement in US terms of the income and formula factors for each component part of a group operating worldwide. These effects in turn constitute an element of *tax induced inefficiency* in the world economy, which will inevitably distort trade patterns and inhibit business decisions.

Application to differing economic circumstances

13. These adverse effects can be traced to particular aspects of applying the unitary basis to the conditions and circumstances which exist today. First, when applied on a worldwide basis, the unitary system is of necessity operating in economic conditions which are far from homogeneous. The system works by combining the income of several related corporations engaged in a "unitary" business. Income is then allocated to the taxing state by multiplying the total income of the enterprise by a percentage comprised of the average of the ratios of instate property, payroll and sales to total property, payroll and sales. The precise formula varies from one State to another.

14. The theory underlying this "unitary" approach is that a dollar of payroll or property spent or a dollar of sales made in one tax jurisdiction produces roughly the same amount of taxable income as a dollar so spent or sales made in another tax jurisdiction. This theory manifestly falls down when applied to two (or more) countries whose economic circumstances are very different. For example, in a developing country property and payroll costs may be very low, relative to those in the United States. On the other hand profits will probably be higher to reflect the risks of expropriation, currency exchange limitations, or other factors. Applying the unitary basis to a group operating both in the USA and a developing country will thus result in a reallocation of group's income from the developing country to the USA. Quite apart from the implications for the group itself (which are discussed in more detail below), it must be open to question whether this represents an equitable division of world resources.

Incompatibility with arm's length basis

15. Second, because international trade relations operate on an entirely different (i.e. arm's length) basis, the worldwide application of the unitary system produces results which are at best anomalous and at worst give rise to serious inequities. In sharp contrast to the unitary method (see above), the arm's length method requires the income of each corporation to be computed on a separate accounting basis under the assumption that each member of a corporate group must deal with the other members as if they were wholly separate entities owned by unrelated interests. This method has now been recommended by both the OECD and UN model treaty and enshrined in a worldwide network of bilateral treaties to prevent double taxation, including those treaties to which the USA is a party. In addition, following the lead given by the US Federal Authorities in 1928, virtually all developed countries have now adopted the arm's length standard for preventing tax avoidance through artificially fixed inter-company prices.

16. The unitary method and the arm's length method are not compatible. Applying the unitary formula to groups which also operate in countries which work on the arm's length basis leads to cases of double taxation. It has been argued that the unitary basis does not in fact tax the foreign source income of foreign corporations related to the "unitary" company. Instead that income is merely taken into account in order to determine the net income attributable to activity within the "unitary" state. But the arithmetical results of applying a unitary formula belie this argument. The "unitary" state is in effect requiring a consolidated income tax return and subjecting to tax the income earned by foreign members of the unitary group without giving any relief for overseas tax. In other words it has extended its jurisdiction to bring into its tax net income over which other states will have exercised their priority taxing rights under the normal arm's length arrangements.

17. The element of double counting this involves can and does lead to multinational groups being taxed on more than 100 per cent of their income. This may represent an additional financial cost for the group itself, which is inequitable. Or it could lead to a diminution of the revenues flowing to any exchequer which seeks to avoid double taxation by giving credit for the "unitary" tax paid – a result which at best can be described as anomalous. These inequities and anomalies are particularly acute in the – not uncommon case – where the US company of a unitary group operates at a loss. Even though it had made no profit by any normal commercial standards, the US company would be liable for tax in respect of a proportion of the worldwide profits of its foreign affiliates. In other words there would be an element of direct subsidy from the worldwide group (or foreign revenue as the case may be) to the unitary state.

Unitary basis is not uniform

18. Third the unitary basis is not – and cannot be – uniform in its application. The very concepts it uses are incapable of precise definition, at least on anything other than a very local basis. It is notable that, even amongst the various states within the USA, there are significant variations first in the criteria used for determining whether or not a particular corporation is "unitary", and second in the formula to be applied to unitary corporations. Even within an individual state it is by no means unknown for a business which has been deemed "unitary" one year to be classed as non-unitary the following year, and for the basis of calculating its tax liability to vary from one year to the next. As a result no business can be sure whether or not it will be adjudged to be "unitary" and if so, how its tax bill will be calculated. In other words the unitary basis breeds uncertainty. The problem this creates for business is heightened by the lack of any procedure analogous to that embodied in "arm's length" tax treaties for resolving disputes about the application of the rules to individual cases.

Unitary basis imposes high compliance costs

19. The fourth aspect of the unitary basis which contributes towards its damaging effects is the compliance costs it involves. It is for the companies themselves to tell the Working Group what complying with the unitary system means in practice. The UK Government would merely note that the full requirements of the system necessitate, at a minimum, the translation into US dollars of accounts maintained by related companies in a multitude of different currencies and the preparation of extra sets of accounts to meet the specific, and varying, requirements of the unitary states. And we understand that the details requested often reflect confidential data, trade secrets, or other information that cannot be made available for reasons totally unrelated to tax considerations.

20. Of more direct concern to the UK Government is the extent to which the unitary states' demands for financial information may involve investigation of the records of UK companies which are outside the USA. More often than not, the substantial majority of the records required describe business transactions that are entirely unrelated to activities within the United States. This is objectionable in principle, as well as producing excessive compliance burdens in practice.

Comparison of unitary method with arm's length method

21. By contrast, the arm's length method, though not perfect, avoids these four very real problems which inevitably arise when the unitary basis is applied worldwide. First by focussing on the amount of profit that would have been made within an individual country by independent parties dealing at arm's length, it recognises that companies operating in different economic circumstances will incur different costs and run very different risks. Second, there is of course no question of the basis being incompatible with internationally accepted methods – the arm's length basis *is* the internationally accepted method. Equally, the 'international' nature of the arm's length method helps to avoid the third problem – the lack of any uniform rules. Because it has been for so long the guiding principle of international tax, there has been time to smooth out the 'rough edges' of the arm's length method. The countries of the world have evolved a series of internationally accepted standards which are capable of exact definition under clearly applied procedures. So the various problems identified earlier – of double taxation: of companies being liable to tax on more than 100 per cent of their income: of companies being liable to tax in respect of profits when, on normal commercial principles, they are making a loss – simply do not arise or where they do, they can be satisfactorily resolved.

22. The fourth problem, that of high compliance costs for companies, equally does not arise to anywhere near the same extent under the arm's length method. The information required in order to operate this method is, more often than not, information which companies have already had to prepare for other purposes. The use of accounts drawn up to comply with company law requirements is a good example of this.

23. Generally, therefore, when measured against the criteria for judging a tax basis the arm's length basis is on each count preferable to the worldwide unitary method. It is at once more equitable, more certain, simpler and more conducive to efficiency. Nor does there seem any good reason why it should not serve as an effective policing mechanism to protect the revenue of individual states. There is an extensive body of Treasury Regulations under Section 482 of the Internal Revenue Code of 1954 providing definitive guidelines governing the fiscal relationships of commonly-controlled corporations. Moreover we understand that, under long-standing accords, information gathered by the United States Treasury from Federal tax audits is continually made available to the individual States. Against this background, the majority of States have felt able to operate an arm's length system, and to apply this rule to subsidiaries of multinational group resident within their jurisdictions.

Wider consequences of the unitary system

24. Any set of rules which fails to measure up to the criteria of a good tax system must be expected to have adverse consequences which go well beyond the immediate impact of that set of rules itself. This is certainly the case with the current application, by several US States, of the unitary system on a worldwide basis.

25. First there is now evidence that it is inhibiting trade relations and distorting investment patterns. In the light of the inequities, anomalies and uncertainties generated by the tax rules, foreign corporations are re-appraising the benefits and burdens of conducting business within a unitary state. The recent decision by the London Chamber of Commerce to cancel its mission to Florida on account of Florida's adoption of the worldwide unitary basis is a good example of this.

26. Furthermore, the spread of unitary taxation amongst the various States can only serve to undermine the very strong position that the United States has adopted in OECD and elsewhere for the liberalisation of international investment flows. The position was restated only a few weeks ago by President Reagan himself in his 9 September Statement on US policy towards international investment. The continued imposition of unitary taxation is incompatible with this stance.

27. These adverse consequences for worldwide trade and investment would be even worse if other countries respond to the States' application of unitary tax by taking retaliatory measures or introducing unitary systems of their own. In particular the States' operation of the worldwide unitary basis , and the US Federal Government's failure to prohibit this system, may well serve as an example which other countries will soon choose to follow. In particular some developing countries may feel that the system has its attractions for them. If such countries adopt unitary tax, they would be unlikely to follow the three factor formula used, for example, in California. The very different economic conditions which prevail in the developing world would naturally incline them to develop or emphasise factors which allocate a greater proportion of income to the developing country. They might for example focus simply on sales.

28. The effects of other countries taking retaliatory measures, or unitary tax spreading outside the United States, will be keenly felt by the United Kingdom. This is because the UK invests on a substantial scale in foreign countries in both the developed and developing world. But if the UK is a substantial investor in foreign countries, the United States is a much larger one. So the adverse impact on the United States must be expected to be much greater. As things stand at present the economic burden this imposes will, in large part, fall on the United States Federal Government. Because the United State's Internal Revenue Code allows a credit against United States taxes for taxes paid to a foreign country (subject to certain limitations), any increase in foreign taxes could be offset dollar for dollar by a reduction in United States taxes.

III. CONCLUSION

29. In this paper the UK Government has analysed the worldwide unitary system by reference to the universally-accepted criteria of a good tax system – equity, certainty, simplicity and the promotion of economic efficiency. It has demonstrated that, when applied in the present international context, the worldwide unitary method inevitably produces results which are inequitable and uncertain. The method involves additional compliance costs for companies. Furthermore it is in the United Kingdom Government's view objectionable in principle that the method can require the disclosure of the records of companies outside the USA, particularly as these will often apply to transactions entirely unrelated to activities within the United States.

30. If the worldwide unitary system is allowed to persist it will hamper rather than promote economic efficiency distorting investment patterns and inhibiting trade throughout the world. It makes it impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment. This framework is particularly crucial at the present juncture in the development of the world economy, when businesses are seeking profits throughout the world without regard to national boundaries. The narrow economic standpoint of the unitary system is incompatible with the harmonious relationship that is the goal of our governments, to the benefit of the American and British people alike.

CIAT: 18th GENERAL ASSEMBLY (20 - 25 MAY 1984)

MEASURES FOR IMPROVING THE LEVEL OF VOLUNTARY COMPLIANCE WITH TAX OBLIGATIONS

The subject of measures for improving the level of voluntary compliance with tax obligations will be discussed at the 18th General Assembly of CIAT (Centro Interamericano de Administradores Tributarios – Interamerican Center of Tax Administrators) to be held 20 - 25 May 1984 in Cartagena (Colombia).

The last time the subject of voluntary compliance was discussed was in 1981 in Mexico during CIAT's 15th General Assembly which was dedicated to the topic: "Voluntary compliance: myth or reality ?". The main theme of the 16th General Assembly held in 1982 in Paraguay was closely related since it dealt with tax *non*-compliance.

For purposes of the 18th General Assembly, 6 topics have been identified:

1. *The concept of voluntary compliance.* This subject will respond to CIAT members' interest in examining in detail such aspects as fairness and simplification of the tax legislation, the impact of the tax administration's effectiveness on voluntary compliance, taxpayer assistance, information and education. Also external aspects over which the tax authorities have no direct control will be considered, such as taxpayer behavior, social consciousness and the impact of governments' socio-economic policies.
2. *Improvement and simplification of the legal tax system.* This subject will deal with the effects of legislation aimed at promoting voluntary compliance. Aspects which will discussed are:
   - *the tax structure:* the impression a taxpayer may have about the fairness or unfairness of the taxation system, which will determine his level of resistance;
   - *formal taxpayer obligations:* a system which demands excessive formal and other obligations from taxpayers will be an obstacle for the promotion of voluntary compliance. Very often it will be necessary to achieve an adequate balance between the complex elements in the taxation system and the desire to simplify it as much as possible to facilitate compliance. Aspects which merit discussion are: self-assessment, withholding at source, accounting records, preservation of documents, and simplified procedures to determine the tax base;
   - *specific measures to promote voluntary compliance:* limitations to the administration's power to investigate (e.g: bank secrecy), power of the administration to enforce collection of delinquent debts, tax sanctions and their effective application, tax amnesties or moratoriums, publication of sanctions and the granting of incentives to taxpayers.
3. *The impact of the level of effectiveness of the tax administration.* The effectiveness of the tax administration is of vital importance for promoting taxpayer compliance. Factors which play a role are its functional structure, information systems and administrative procedures adapted to the administration's requirements as well as trained and motivated staff.

   Some aspects which should be analyzed are:
   - *organization:* this must be sound and reliable so that the taxpayer may expect a positive attitude in his relationship with the tax administration;
   - *information systems:* the administration must use computerized information systems and manual procedures which must be updated and be easy to handle;
   - *human factor:* the administration should motivate the tax officer to develop a positive attitude towards the fulfillment of his job and toward seeking voluntary compliance by the taxpayer.
4. *Individual behavior and tax consciousness.* This topic will be discussed from three different viewpoints: psychological, anthropological and educational.
5. *Taxpayer assistance, information and education.* This subject will focus on assistance rendered in filing tax returns and, in general, giving information, including educational programs for young persons.
6. *Concrete measures for improving voluntary taxpayer compliance.* This subject will first be discussed in working groups. The results will be discussed at a plenary session.

Electronic Industries Versus Unitary Taxation[1]

More than a dozen U.S. states currently impose a unitary tax on corporations, in which a company's earnings not only on its in-state operations but also on its nationwide and even worldwide operations are subject to state tax. Many other states are now considering introducing a unitary tax. Such a trend discourages foreign investment in the United States and could damage U.S. economic relations with other countries. Legislation seeking to abolish the unitary tax is now before both houses of the U.S. Congress.

Below is the text of a pamphlet, issued by the Electronic Industries Association of Japan[2] in August, urging support for these bills.

PREFACE

It is of paramount importance that the United States and Japan work together to maintain positive economic ties. Any serious impediments must be eliminated through joint efforts.

Recently, Japanese business leaders have become particularly concerned about the so-called unitary tax policy of certain states in the United States. The U.S. Supreme Court's approval of this taxing procedure in the *Container Corporation of America* decision has caused Japanese business leaders to reconsider their investment decisions, especially as they apply to states maintaining the unitary tax system.

As a positive contribution to U.S.-Japan relations, many Japanese companies have invested in America's manufacturing sector in response to the strong request made by the Trade Subcommittee of the House Ways and Means Committee in 1979 for Japan to return capital and jobs to the United States through investment in the manufacturing sector. Having already made substantial investments that are contributing to the creation of jobs, increased payrolls, and an improved U.S. trade balance vis-à-vis Japan, these Japanese companies are now falling victim to double international taxation as a direct result of the unitary tax system. Without the support of the federal government and the U.S. Congress in opposing the state unitary tax method, foreign investment in the United States will be discouraged and U.S.-Japan trade relations will worsen.

This message is one of support for legislation proposed by Senator Charles Mathias (S 1225) and Representative Barber Conable (HR 2918), who both seek the abolition of the unitary tax system through federal legislation. Passage of these bills will be a welcome development to the Japanese business community.

The gravity of this issue should not be overlooked. It must be resolved, and with your kind support our mutual efforts can contribute to improved economic relations between the United States and Japan.

WHAT IS UNITARY TAXATION?

With the increasing internationalization of business activities, the number of enterprises establishing affiliates or subsidiaries overseas has grown. It is quite obvious today that major firms conduct business through a worldwide network linking the nations of the world. In this environment, it is most desirable for all nations of the free world to engage actively in reciprocal direct investment.

The trend toward reciprocal investment, however, is now being confronted by the unitary tax issue. Under the unitary taxation system, the average income of all subsidiaries of a company throughout the world becomes subject to taxation. Stated more specifically, taxation of the income of a subsidiary in some states of the United States is calculated according to the amount of property, payroll, and sales of not only the subsidiary concerned but also that subsidiary's parent company and all other subsidiaries of the parent, regardless of their location.

When the business operations of a subsidiary are launched, a large amount of capital investment is necessary for the construction of plants and facilities and for hiring employees. However, the subsidiary's income is usually lower than that of other companies within the corporate group until its assets have depreciated to a cer-

1. This pamphlet was reproduced from KKC BRIEF No. 12 of October 1983 at 1 published by the KEIZAI KONO CENTER (Japanese Institute for Social and Economic Affairs) where it appeared under the title: "Requesting support of Bills to abolish Unitary Taxation; Why pass the Mathias and Conable Bills").
KKC BRIEF is an occasional publication of the Keizai Koho Center. Issued several times a year, it provides, in a concise format, news on the activities and views of Keidanren (Japan Federation of Economic Organizations) and other private Japanese economic organizations, as well as information on particular industries and the Japanese economy in general. KEIZAI KOHO CENTER is a private nonprofit organization that works in cooperation with Keidanren to provide information on the Japanese economy.
2. The Electronic Industries Association of Japan is an organization of approximately 600 electronics manufacturers in Japan. The electronics industry is especially vulnerable to the fast changing demands of today's industrial and consumer societies. Just keeping up with the daily shifts and requirements in this fast-paced, globally sensitive society takes an enormous amount of knowledge and the ability to handle it wisely. The Electronic Industries Association of Japan was organized to meet this need.

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tain degree. Therefore, should unitary taxation be applied according to the above-mentioned formula, the income tax of the subsidiary would become much larger than actually warranted. This would naturally discourage further investment in the subsidiary, or for that manner in the area covered by unitary tax methods.

Table 1 shows one example of the unitary taxation formula.

Unitary taxation has been officially adopted in the following 14 states: Alaska, California, Colorado, Florida, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon, and Utah. India and Nigeria are reportedly favorably considering the unitary taxation system.

UNITARY TAXATION DETRIMENTAL TO U.S.-JAPAN ECONOMIC RELATIONS

Japanese businesses are contributing to the development of the U.S. economy by establishing business operations in the United States. But unitary taxation threatens to inhibit such operations. At present, 134 (56.3%) of the 238 Japanese capital enterprises in the United States are located in states where the unitary taxation system is being implemented (Tables 2 and 3). Thus many Japanese companies are already feeling the system's effects. Furthermore, if Japanese enterprises were to relocate their offices to avoid unitary taxation, the U.S. employment situation would be dealt a serious blow.

Table 1
The unitary tax formula

	Headquarters in Japan	Subsidiary in London	Subsidiary in California	Total
Property	1,500	150	500	2,150
Payroll	800	100	500	1,400
Sales	2,500	800	1,200	4,500
Profit	250	100	50	400

The rates of the three factors for the subsidiary in California against the total of the group are as follows:

Property	500/2,150 = 0.232
Payroll	500/1,400 = 0.357
Sales	1,200/4,500 = 0.266

The average of the above rates is

$(0.232 + 0.357 + 0.266)/3 = 0.285$

The profit of the subsidiary in California is obtained by using the average rate under the unitary taxation formula.

$400 \times 0.285 = 114$

Thus, state tax would be assessed on the amount of 114 rather than the original profit of 50.

Table 2
Distribution of Japanese enterprises by capital and number of employees

(unit: number of factories and establishments)

Capital	Atlantic region	Southeast region	Midwest region	Northern Pacific region	Southern Pacific region	Total
Less than $10,000	1	0	0	1	0	2
$10,000-$500,000	6	3	2	8	17	36
$500,000-$1 million	7	2	3	3	4	19
$1 million-$10 million	18	8	7	16	31	80
More than $10 million	6	7	5	6	4	28
Employees						
Less than 30	6	4	3	13	13	39
30-100	15	7	9	12	17	60
100-300	14	5	5	4	15	43
300-500	4	3	1	2	6	16
More than 500	1	4	3	4	5	17

Source: *The United States of America*, Trade and Market Series 223, Japan External Trade Organization, June 25, 1982.

Table 3
Distribution of Japanese enterprises by location

(unit: number of factories and establishments)

Atlantic region	54	Midwest region	37
Massachusetts	5	Nebraska	2
Rhode Island	2	Missouri	3
New York	5	Wisconsin	2
New Jersey	7	Illinois	10
Pennsylvania	5	Michigan	9
Maryland	2	Indiana	6
Virginia	1	Iowa	1
North Carolina	5	Ohio	2
South Carolina	4	Kansas	1
Georgia	11	South Dakota	1
Florida	4		
Puerto Rico	3	Northern Pacific region	57
		Northern California	17
Southeast region	29	Oregon	4
Texas	12	Washington	9
Louisiana	1	Alaska	25
Oklahoma	2	Idaho	2
Arkansas	2		
Mississippi	2	Southern Pacific region	61
Alabama	2	Southern California	56
Tennessee	6	Colorado	2
Kentucky	2	Arizona	1
		Hawaii	2
		Total	238

Source: *The United States of America*, Trade and Market Series 223, Japan External Trade Organization, June 25, 1982.

The major problems of the unitary taxation formula can be summarized as follows:

(1) It hampers active investment by foreign enterprises in the United States.
(2) It results in double taxation.
(3) It distorts the principle of taxation agreements with foreign nations.
(4) No state has the authority to apply taxation to offshore income.

TWO JAPANESE COMPANIES' EXPERIENCES

The case of Kyocera

Kyocera Corp. established Kyocera International in San Diego, California, and began local production in 1971. The number of local employees as of March 31, 1983, was 1,850, and they are engaged in manufacturing IC packages.

Kyocera International paid approximately $18 million in federal tax and $3.5 million in state tax between 1972 and 1983 in accordance with the established taxation procedures. Its accumulated profit after tax was approximately $22 million in 1983.

Nevertheless, the Franchise Tax Board of California has applied the unitary concept to Kyocera Corp. and Kyocera International and is attempting to collect a penalty tax of about $21 million (including interest) for the period between 1972 and 1983. This penalty tax will naturally result in double taxation. Furthermore, if this penalty tax is paid, the four-year average rate of state tax in real terms between 1979 and 1983 would be approximately 101%. In other words, California's tax board is demanding state tax exceeding the income of Kyocera International.

The U.S. effective tax rate (the proportion of federal and state tax to net corporate profit) is 51%, while that of Japan in the case of Kyocera Corp. (rate of the sum of corporate tax, enterprise tax, and local tax) is about 53%. Therefore, it can be said that the consolidated profit of Kyocera is reasonably taxed under the independent accounting systems of the United States and Japan. At the same time, the tax amount for consolidated profit is not subject to change even if the profit is transferred. Thus it is evident that application of the unitary tax formula implies double taxation.

The case of Sony

Akio Morita, chairman and chief executive officer of Sony Corporation, has stated:

> The Sony Corporation first constructed a color television plant in San Diego, California, in 1972. With the introduction of cathode ray tube production facilities in 1974, Sony's San Diego plant became a fully integrated factory. In 1982, ten years after entering California, we witnessed the production of approximately 700,000 American-made Sony Trinitron color television sets.
>
> Sony's plant in San Diego was highly welcomed by the local community. Indeed, Sony's transfer of its color television production technology gave a significant boost to the local economy to the extent of a present work force of about 1,800 people. However, Sony's contribution to California's economy is now in serious jeopardy as a result of the state's unitary tax system.
>
> The unitary tax system has put a tremendous burden on us. Even when we do not make profits from our operations in California, we are forced to pay an income tax from profits created outside of California. The California unitary tax system's extraterritorial effect is totally unfair.
>
> Sony is now being forced to stop additional investment in its San Diego plant because of this tax system. Similarly, when we were considering constructing a video recording tape plant in the United States, we excluded California from the beginning because it imposes a unitary tax. We constructed our magnetic tape plant in Dothan, Alabama, in 1977 primarily because Alabama does not use the unitary tax method.
>
> It appears contradictory to us that California maintains a tax policy that discourages foreign investment at the risk of losing such investments to states that have not adopted the unitary tax system. As state deficits continue to grow, revenue measures that serve to double-tax investors will cause foreign investors, and especially Japanese investors, to stop increasing their investments in states that employ the unitary tax system.
>
> Sony has filed a claim with the state agency in charge of tax disputes because of the tax assessed on the San Diego plant by the state tax authorities. Should our efforts to resolve this inequitable tax system prove fruitless, we will be left in the undesirable position of never again investing in California or any other unitary tax system states.
>
> The adoption of the unitary tax system by other states will work against the efforts being conducted to alleviate the tremendous trade problems presently existing in the world. We at Sony are making our best efforts to assure that further barriers to world trade and investment are not erected.

BOTH U.S. AND JAPANESE BUSINESS LEADERS OPPOSE UNITARY TAXATION

Recommendation by the Japan-U.S. Economic Relations Group

> While there are many sound reasons for terminating unitary taxation systems (for example, they are administratively burdensome and can result in double taxation since they may assess taxes on income derived outside the taxing jurisdiction without any compensating tax writeoff elsewhere), we hope legislators on both the state and the Federal levels will take into consideration their deleterious effects on foreign investments and foreign relations. *Supplemental Report of the Japan-United States Economic Relations Group,* October 1981.

Recommendation by the U.S.-Japan Businessmen's Conference

> We therefore recommend that the unitary tax system be abolished by state legislatures or carefully controlled by federal law enacted by the U.S. Congress to avoid double taxation and prevent any disincentive effect upon foreign direct investment in the United States. *Agenda for Action,* Joint Task Force Report by the U.S.-Japan Businessmen's Conference, July 1983.

Resolution by Keidanren (Japan Federation of Economic Organizations)

> Extending the scope of application of the unitary tax formula to incomes generated outside the United States is a serious aberration from the internationally recognized norms of corporate income taxation. It is liable to result in double taxation and run into conflict with the widely accepted principles of taxation as well. Such an unreasonable taxation policy is viewed with serious concern not only

in Japan but throughout the world . . . Acting on the consensus of the Japanese business community, Keidanren strongly seeks abolition by the states concerned of the application of the unitary tax formula to foreign-source incomes in the shared interest of sound development of Japan-U.S. economic relations. "Resolution Urging Abolition of the Unitary Tax Formula Based on Worldwide Income by State Authorities of the United States of America," Keidanren, December 8, 1981.

OTHER NATIONS ALSO OPPOSE UNITARY TAXATION

The unitary taxation issue is not only a bilateral problem between the United States and Japan. Unitary taxation is viewed as a disincentive for investment in the United States by a number of nations. At the same time, legislation calling for the abolition of unitary taxation has been submitted to the U.S. Congress.

Notes on unitary taxation by the European Community

Note by the EC (March 19, 1980):
This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss . . .

Note by the EC (Oct. 30, 1981):
Our Governments remain firmly convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory.

Note on unitary taxation by the EC, represented by the Embassy of Greece in Washington, D.C. (Aug. 1, 1983):
Our governments therefore urge that the United States government should give strong support to legislation to ensure that States do not use that method of taxation at least for the subsidiaries of foreign corporation.

Letter from the Chancellor of the Exchequer of the United Kingdom to Mr. Donald Regan, Secretary of the Treasury (July 12, 1983)

This method carries a high risk of double taxation, and imposes on international companies a heavy administrative burden.

Protest letters from the Canadian government

From the Ambassador to the United States to Senator Charles Mathias (June 2, 1983):
Your recent action introducing legislation that would prohibit state governments from using the worldwide combined reporting system in taxing international corporations (Bill S. 1225) was recently drawn to my attention and I wanted to express my Government's support for this initiative.

From Jacques S. Roy, chargé d'affaires, to Mr. John E. Chapoton, assistant secretary of the Treasury (June 20, 1983):
For some time now Canadian authorities have expressed their concern about the unitary tax apportionment method used by certain states in this country.

From Jacques S. Roy, chargé d'affaires, to Mr. Robert McCormack, assistant secretary of state for economic and business affairs (June 21, 1983):
. . . I would like to take this opportunity to encourage the State Department to support this legislation."

From Marc Lalonde, Minister of Finance, to Mr. Donald Regan (Aug. 11, 1983):
The unitary method of taxation is a cause of considerable concern to a number of Canadian-based multi-national corporations . . . The unitary method . . . gives rise to a serious potential for double taxation.

Aide-mémoire presented by the Japanese government to the U.S. government (Aug. 11, 1983)

ZAMBIA:

1984 Budget Speech

By Bernadette P. Davey

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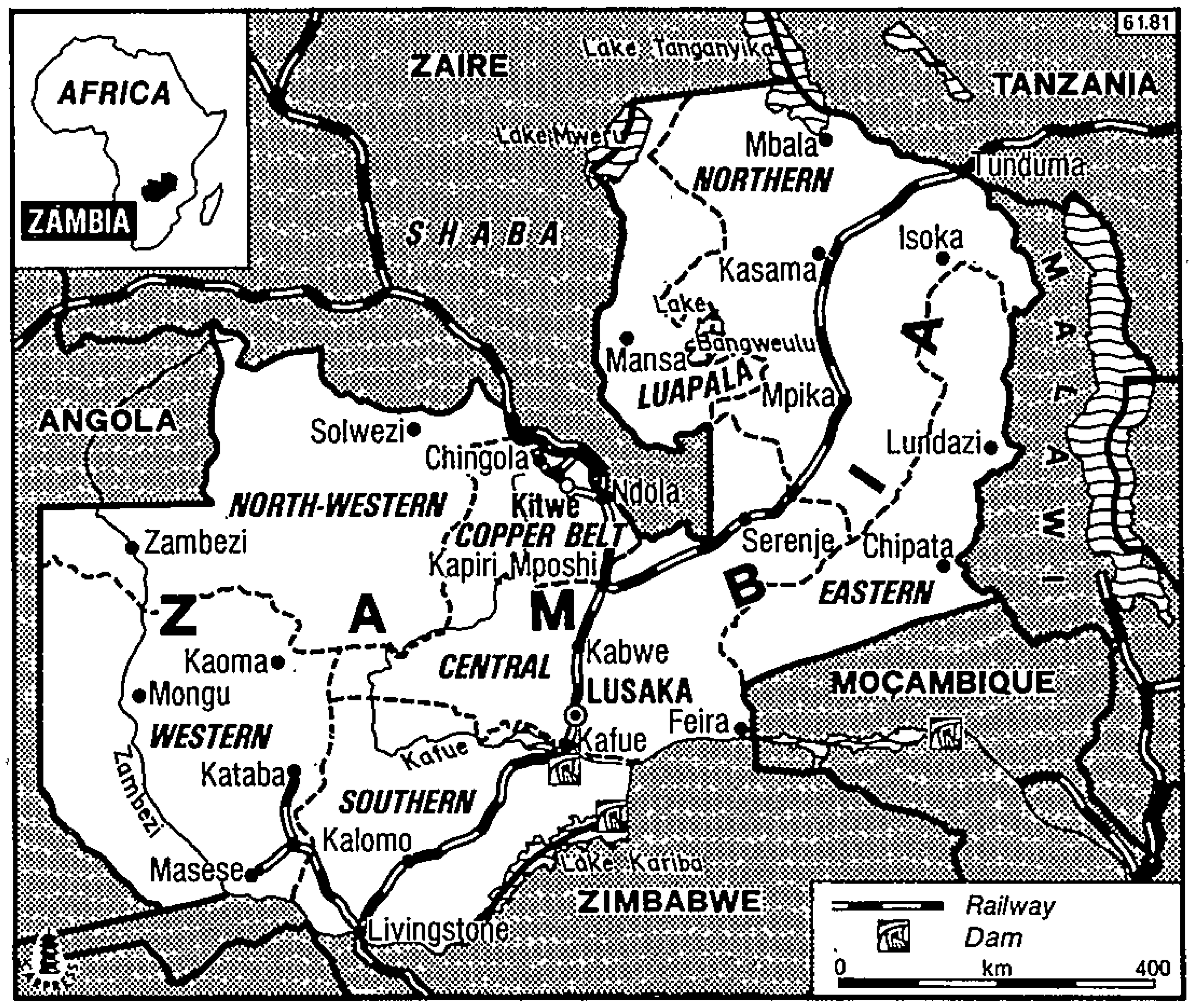

On 27 January 1984, the Minister of Finance, the Honourable L. Mwananshiku, M.P., delivered his Budget Speech to Parliament. In what has been described as the "farmer's budget",[1] once again the Government emphasized its long-term policy objectives of diversification of the economy from mining to agriculture and the promotion of exports.

In his assessment of the economy's performance during 1983, the Minister of Finance was not encouraged.[2] The principal problems encountered by the Zambian economy over the past year were, in general, similar to those facing all other non-oil exporting developing countries. The high rate of the U.S. dollar caused an increase in the cost of importing oil and other raw materials, in addition to the extra burden of servicing loans. The economy was also beset by problems such as a continuation in the fall of per capita Gross Domestic Product, a shortage of spares in the mining sector and the persisting over-dependence on earnings from copper.

With these difficulties in mind, the Minister announced a wide variety of measures in his Budget Speech. The main thrust of the proposals is an increase in revenue yield from taxation[3] and the provision of incentives to encourage a rise in foreign exchange earnings. Although the impact of the Budget proposals is also directed at the diversification of the economy towards agriculture, in fact the Budget contains very little by way of major tax concessions to farmers.

The following are the main changes to the tax system outlined in the Budget Speech. The proposed measures contained in the Budget may, however, be altered during the passage through Parliament of the 1984 Income Tax Bill.

INCOME TAX

Several major changes are proposed to the income tax system as it affects companies and industry. The rate of corporation tax is to be increased from 45% to 50% with effect from 1 April 1984. The tax rate applicable to profits arising from exports of "non-traditional" products excluding mining and electricity will be reduced to 15% in an attempt to promote such exports. This measure is also due to take effect from the beginning of April 1984. Farming profits are already taxed at this reduced rate and no change will be made here. It is also proposed to introduce legislation to disallow the carrying back of losses. However, it is still possible to "average" over 2 years income which is derived from farming or fishing.

In respect of the taxation of individuals, a variety of changes due to take effect on 1 April 1984 is included in the Speech. No alteration is being made to the rates. However, some personal allowances will be increased. The annual handicapped persons' allowance is raised from 500 ZK to 600 ZK and the child allowance is inceased from 275 ZK to 325 ZK per annum. In future, dividends received by an individual will be computed as separate income and taxed at a flat rate of 35%. In addition, rents payable to residents will be subject to a withholding tax at a rate yet to be announced. A similar withholding tax is currently applied to such payments made to non-residents. Finally, a measure is being introduced to raise the level of the valuation, for income tax purposes, of housing supplied gratuitously by an employer to an individual. This will be taxed from April 1984 at up to 4,000 ZK per annum or 25% of the taxpayer's assessable income, whichever is the lesser amount.

INDIRECT TAXES

A number of changes were proposed in the field of indirect taxation including the introduction of a new tax on the transfer of property.

The new property transfer tax, announced by the Minister, will apply to those persons selling residential, commercial, industrial or agricultural property. The tax will amount to 2.5% of the total selling price. A further tax at a rate of 2.5% will be levied on the value of shares

1. "Zambia – budget promises difficult year", by Sue Turner and Abbey Maine, *African Economic Digest*, 3 February 1984, p. 17. This refers only to the general theme of the Minister's speech as no tax concessions were granted to the agricultural sector.

2. In paragraph 16 of the Budget Address, the Minister stated, "Owing to the unfavourable conditions in the international economy, the problems of the oil importing countries have included prolonged weakness in their principal export markets, a sharp increase in the price of oil, adverse changes in the non-oil terms of trade and very high interest rates on their external debt".

3. The Minister refers to the Government's medium-term policy objective to match "recurrent expenditures with recurrent revenues." Paragraph 71 of the Budget Address.

traded.[4] These measures will take effect from 1 April 1984.

It was announced that the rates of sales tax are to be increased. The rate on telecommunications services will rise from 10% to 15%, electricity from 12.5% to 15%, and the rate for textile fabrics is increased from 15% to 20%. In addition, a number of excise duties will be increased. Such increases apply mostly to alcoholic beverages, cigarettes and petroleum products.[5] Most of the increases take effect from 28 January 1984. It was also proposed to raise the customs duty on a number of capital goods with effect from 28 January 1984.

Several new measures were announced which would increase revenue yield by means of the introduction of licence fees. Fees are to be charged in future for the issue of prospecting and mining licences on a per hectare basis. The rates of fee range from 10 ZK to 500 ZK per hectare depending on the type of metal or of stone being mined. Bookmakers will also be required to pay a licence fee. The initial licence will cost 1,000 ZK and annual renewals will be 500 ZK. Hotels will be charged fees for their licences ranging from 25 ZK to 500 ZK depending on the grade or standard of the accommodation provided. Finally, casinos will also be subject to a licence fee. They will be required to pay an annual fee of 650 ZK plus on additional amount which is based on the number of games offered with a minimum of 2,000 ZK.[6]

INCENTIVES

In addition to the introduction of a rate of tax of 15% on the profits from export of non-traditional products, another measure was announced with a view to encouraging exports and reducing administrative difficulties previously encountered by exporters. Exporters are to be permitted to retain 50% of their foreign exchange earnings from export. They may use such retained proceeds for imports or to clear items in the pipeline without the necessity to make application to the Bank of Zambia. Furthermore, producers of emeralds exporting through the Reserved Minerals Corporation will be allowed to use 10% of their foreign exchange earnings to import necessary inputs for their industry and to clear items through the pipeline.

CONCLUSION

As it appeared last year,[7] Zambia's economic prospects have not markedly improved during the previous financial year, and the country faces yet another difficult year. The Government's ability to meet its foreign exchange promises, in particular to ensure that the agricultural sector has priority in foreign exchange allocations, will continue to remain uncertain. The policy of encouraging the agricultural sector will continue. Copper production will probably remain at its present level. However, due to the world recession, the room for manoeuvre in the Budget was restricted, particularly as much of the future development of the Zambian economy depends to a large extent on external factors such as the value of the U.S. dollar, debt re-scheduling, the price of oil and the price of copper.

The Minister made it clear that the Zambian economy must diversify. He pointed out, "There are no easy solutions. We also need to shift the resources to the agriculture and the rural sector which is the area of priority."[8] He concluded his Address by calling for sacrifices to be made, "to ensure that problems facing our country are urgently tackled and resolved".[9] It remains to be seen whether such sacrifices will bring the hoped for improvements.

4. It is assumed that this levy is imposed on the value of shares traded in property companies.
5. For example: Potable spirits raised by 50 ngwee per bottle, diesel by 2 ngwee per litre, soft drinks by 2 ngwee per bottle. See generally *African Tax Systems,* published by the International Bureau of Fiscal Documentation, Zambia II.
6. This increases to 3,000 ZK per game where more than 10 games are provided.
7. See Emmanuel, A.B.C., "Zambia's 1983 Budget", 37 *Bulletin for International Fiscal Documentation* 11 (1983) at 491-492.
8. See paragraph 131 of the Budget Address.
9. See paragraph 133 of the Budget Address.

ZAMBIA:

Budget Address 1984

Extracts from the Budget Speech pronounced by the Minister of Finance, the Hon. L.J. Mwananshiku, MP, on 27 January 1984.

THE 1984 BUDGET

90. Mr Speaker, Sir, I now turn to the budget for 1984. Before I discuss the levels of expenditure and the means of financing them, I would like first to discuss two preliminary matters. The first relates to the fiscal policies underlying this year's levels of expenditure and the second deals with the presentation of the expenditure figures in the Estimates of Revenue and Expenditure.

(a) Fiscal policy

91. Sir, earlier in my statement, I have referred to the need for us to reduce the level of the deficit as a way of combating inflation and reducing the pressures on the balance of payments. The budget for 1984 seeks to move in this direction. The total budget deficit, as a percentage of GDP is being reduced in comparison with fiscal years 1982 and 1983 when it was 21.5 per cent and 7.3 per cent respectively. It is my hope that we can continue with this policy until the deficit is reduced to around 5 per cent of the gross domestic product by fiscal year 1986. This policy will be pursued on two fronts. Firstly, and as I have already stated, revenue collections will be improved. Secondly, the rate of growth of public expenditure will be restrained to take account of the revenue constraint. Indeed, in some sectors the allocations in this year's estimates have been reduced from the levels of the previous years. I should also mention, Sir, that the growth of the public service will continue to be checked. Mr Speaker, Sir, in contrast, allocations to agriculture and the rural sector have been increased in line with the policy to boost agricultural production and the creation of employment in this area.

92. Mr Speaker, Sir, the other policy issue I want to deal with concerns aided projects. In the past, the implementation of aided projects has tended to lag behind for lack of

Kwacha counterpart funds. We have this year made every effort to provide the necessary Kwacha counterpart funds. I am confident that this action will enable these projects to proceed smoothly.

. . . .

(d) Revenue measures

100. Mr Speaker, Sir, against the above expenditure, the revenue expected in 1984 is estimated at K1,240 million broken down as follows:

		K
Income tax		335.9 million
Customs and Excise		623.7 million
Fines, Licences, etc.		6.9 million
Mineral revenue		105 million
Interest		16.2 million
Fees of Court, etc.		83.3 million
OSAS		0.8 million
Miscellaneous receipts		0.8 million
Equity Levy		2.5 million
Capital repayments		23 million
Capital grants		41.9 million
	Total	1,240.0 million

101. I must add, Sir, that these figures are not beyond attainment even taking into consideration the problems of the economy to which I have referred. I should mention that even after taking the measures I shall soon discuss, there will still be a deficit or gap of K267.9 million which I shall have to cover by borrowing. I estimate to raise K70 million from local non-bank sources and K57.9 million from abroad. Loans from outside Zambia relate to projects, and local counterpart funds have been provided.

. . . .

102. Mr Speaker, Sir, the problem of raising additional revenue in an economy that is experiencing the difficulties to which I have made reference is not an easy one. New revenue sources are becoming more and more difficult to find. Nevertheless, I believe that with the measures we have taken to strengthen the revenue collecting agencies, it should be possible to increase our receipts. In any case, there is some evidence to suggest that there is still room for increasing revenue from the traditional sources. It is with this in mind that I shall now discuss the new revenue measures for 1984.

(i) Hotel and casino licences

103. Mr Speaker, Sir, at present all hotel establishments are issued with licences in order to operate. However, these licences do not attract any fees. This omission must now be rectified. Consequently, I have decided that hotel establishments should now pay for their licences. Accordingly, I have introduced licence fees as follows:

	K
Five star hotel	500.00
Four star hotel	400.00
Three star hotel	300.00
Two star hotel	200.00
One star hotel	100.00
Ungraded hotel	50.00
Lodge/catering camp	25.00

I am sure that these moderate fees will help us recover the cost of administering and supervising the hotels. This measure will come into effect at mid-night tonight.

104. Mr Speaker, Sir, what I have said about the hotel establishments also applies to casinos. The present casino licences involve no payment of fees. For the reasons I have explained in respect of hotels, I am proposing to introduce fees for casino licences. These fees will be K650 per year. In addition, there will also be other annual fees which will depend on the number of games and tables installed in a casino and also on the volume of gross revenues; for example, where one game only is installed in the casino, the fee payable will be at a moderate level of K2,000 only. Where five games are involved the fee will progress to K7,000. On the other hand, where the games are more than ten then the fees payable will be K3,000 per game.

105. Sir, in respect of each quarter-year during the currency of the casino licence, a sum of K500 will be paid for each table authorised under the licence for the playing of card games. For each gaming machine authorised, the fee for every three months will be K250.

106. Mr Speaker, Sir, there will also be a tax payable on the volume of the gross income, where the gross income of a casino does not exceed K100,000, a fee of 10 per cent will be payable. Any income in excess of K100,000 but less than K300,000 will attract a fee of 12 per cent. The fees will progress until they reach 15 per cent in respect of gross incomes in excess of K700,000. This measure will bring in an estimated K0.9 million.

(ii) Betting

107. Mr Speaker, Sir, I am also proposing to amend the Betting Control Act in order to introduce a licence on book-makers. The licence fees will be as follows:

K1,000	for the first licence
K500	for annual renewals

(iii) Stamp duty

108. Mr Speaker, Sir, Stamp Duty was last raised in 1976. With the serious problems of revenue I have referred to, it has become necessary to increase the rates of stamp duty. Accordingly, I am proposing some adjustments in the levels of stamp duty. The details of the changes are contained in the Stamp Duty (Amendment) Bill which is being published today and which will come into effect tomorrow in terms of Taxation (Provisional Charging) Act, Chapter 594 of the Laws of Zambia.

(iv) Customs and excise

109. Mr Speaker, Sir, under the Customs and Excise Act I am making somewhat extensive modifications, all intended to raise more revenue and to achieve certain economic and social objectives. Under the customs tariff I intend to raise the duty on a select list of capital items. Sir, the Zambian economy is very heavily capital intensive. Quite apart from the balance of payments problems this entails, I fear that we would be reducing the prospects for more employment unless the capital intensity of the economy is lowered. This can best be done by increasing the competitiveness of labour in relation to capital. Accordingly, the duty on a select list of capital goods will be raised with effect from midnight tonight. Henceforth, those who choose to employ more capital rather than labour will have to pay higher customs duties and sales tax for so doing. The additional revenue expected to be raised from this measure is K7.5 million.

110. In terms of excise duties, the following modifications are proposed:

Soft drinks: the duty is to be increased marginally by K0.02 per bottle.

Cigarettes: the duty will go up by K0.02, K0.03 and K0.04 per packet of ten depending upon the quality of the cigarettes. The higher the quality, the higher the increase in duty.

Opaque beer: a small increase of K0.02 per litre is being proposed.

Clear beer: a similarly small increase of K0.02 per bottle is recommended. However, the duty will be suspended until a later day. The price of beer will remain unchanged.

Potable Spirits: an increase of K0.50 per bottle is proposed.

Petrol and Diesel: for premium and regular petrol and for diesel, I am proposing that the increase in duty per litre should be K0.06, K0.04 and K0.03 respectively.

111. Mr Speaker, Sir, the additional revenue from these changes is estimated as follows:

	K
Soft drinks	3.4 million
Cigarettes	2.4 million
Opaque beer	4 million
Clear beer	1 million
Potable spirits	0.1 million
Petrol and diesel	16.3 million

112. Mr Speaker, Sir, let me make two observations in relation to these proposals. The first relates to clear beer and petrol and diesel and the second relates to all the items that attract excise duty. In the case of clear beer I have deliberately kept the increase in excise relatively low because of the problems currently facing Zambia Breweries Limited. The company is looking into these problems in conjunction with Indeco limited. As for petrol and diesel, I have increased the duty not only in order to raise more revenue but also to curb consumption because of the very heavy foreign exchange outlays involved in importing oil. I wish to observe that the proposed increase in the price of petrol and diesel will have only a marginal effect on the operations of the farming community which has continued to enjoy the generous incentives offered by the Party and its Government.

113. Mr Speaker, Sir, all the items attracting excise duty are faithful contributors to Government revenue. In 1982 their total contribution amounted to K268.9 million or 30.6 per cent of the total revenue of K878.7 million. As I have already said, it is important that we continue to assist producers with foreign exchange to enable them acquire raw materials and spare parts. Accordingly, the Ministry of Commerce and Industry and the Bank of Zambia will ensure that producers are given generous allocations of import licences and foreign exchange.

114. These measures take effect from midnight tonight.

(v) Sales tax

115. Mr Speaker, Sir, under sales tax, I am this year raising the tax in respect of three items only. Firstly, I am proposing to raise the tax on telecommunications services from the

current level of 10 per cent to 15 per cent. Through this measure, I hope to raise an additional K0.2 million. I am also proposing to increase the tax on electricity from 12.5 per cent to 15 per cent. This small change should generate an additional K0.25 million. The last items on which I am proposing an increase in sales tax are the textile fabrics. At present certain fabrics attract tax at 20 per cent while others are at 15 per cent. I am proposing to remove this anomaly by raising the tax that is currently at 15 per cent to 20 per cent.

(vi) Income tax

116. Mr Speaker, Sir, I am proposing to make some extensive changes under Income Tax. Some of these changes are intended to promote exports while others are aimed at raising revenue. Some tax concessions are also given. I shall start by dealing with those proposals that are connected with the encouragement of exports.

117. Mr Speaker, I have in this speech stressed the importance of earning more foreign exchange in order to revive our economy. I have already referred to some of the measures we are taking to achieve this objective. Under income tax, I wish to deal with one additional export incentive. This is that all exporters of non-traditional products will now pay tax at the rate of 15 per cent only in respect of the portion of their profits that originates from exports. Mr Speaker, Sir, agriculture which already enjoys concessionary tax rates is not affected by this measure. I should also point out that mining and electricity are also excluded. Mr Speaker, Sir, in the case of emeralds this concession will only apply to emeralds exported through the agency of the Reserved Minerals Corporation.

118. Mr Speaker, Sir, these important tax changes will now place exporters in the same priority category as farmers.

119. Mr Speaker, Sir, I have just discussed measures to encourage exports. I now turn to the discussion of measures intended to raise revenue. The first of these measures relates to property transfer tax. Sir, with the shortage of housing and commercial properties in the country those who are fortunate enough to own real property make a lot of money upon their sale. It is only fair that such income should now attract a specific tax. I am therefore proposing that any person who sells his property should be liable to tax on it as follows:

Residential property – 2.5 per cent of the total selling price.

Commercial industrial and agricultural property – 2.5 per cent of the total selling price.

I am also proposing that there should be a tax of 2.5 per cent on the value of the shares traded.

120. Mr Speaker, Sir, I am also making an important change in the treatment, of dividends for tax purposes. At present, when dividends are declared to a person, they are added to the other income of that person and then taxed as personal income. The effect of this has been to increase unduly the tax paid by such an individual. The consequence of this has been that companies have been reluctant to declare dividends. I am proposing to discontinue the present arrangement. Instead, dividends when declared will now be taxed separately at a fixed rate of 35 per cent. I am confident that this change will assist companies and individuals alike.

121. Mr Speaker, Sir, the third change I wish to make relates to the treatment of housing benefits. At the moment, where a person is supplied with a rent free and/or fully furnished house by his employers, that benefit is taxed only to the extent of K1.500 per year or 12.5 per cent of his assessable income, whichever is the less. With the rapid increase in the rents payable nowadays, there is no doubt that the present way of taxing housing benefits does not reflect reality. I am, therefore, proposing to raise the ceiling to K4,000 per year and the rate to 25 per cent whichever is the less. This is still very much below what would be payable in rent.

122. Sir, another change I am proposing under income tax concern business losses. While business losses incurred in a charge year can be carried forward to subsequent charge years until it is fully extinguished, the Income Tax Act also provides for a loss carry-back. This provision has no incentive effect and has in any case become largely irrelevant now that tax payment on business profits is on a current basis. I am, therefore, proposing that loss carry-back be allowed only in circumstances where income averaging is permitted, i.e. in agriculture and fishing.

123. Mr Speaker, Sir, a further revenue measure I am proposing concerns rent. At present rent payable to persons outside Zambia has the tax due on it withheld at source by the payer who accounts for it to the tax authorities. However, when rent is payable to persons inside Zambia, withholding does not apply since the rent is assessable on the recipient. This arrangement has tended to encourage tax evasion. I am, therefore, proposing to change the law in such a way as to introduce withholding.

124. Mr Speaker, Sir, in order to raise more revenue for the Government, I am also proposing to increase company tax from 45 per cent to 50 per cent. The tax rates applicable to farming and rural enterprises remain unchanged.

125. Mr Speaker, Sir, allow me now to deal briefly with concessions. Owing to the critical situation facing the country I can allow only a few tax concessions. I wish the situation was different. On personal income tax I am proposing to increase the allowances applicable to handicapped persons. These allowances will be increased by 20 per cent from K500 to K600. At the same time child allowances will be raised by 18.2 per cent from K275 to K325. However, the number of children in respect of which this benefit will accrue will remain at six.

126. All these changes under Income Tax will be effective from 1st April, 1984.

. . . .

IRELAND:

Budget 1984-85

Extracts from the Budget Speech pronounced by Mr. A. Dukes, Minister for Finance, on 25 January 1984

See for detailed information on Irish taxes *Supplementary Service to European Taxation, Taxation of companies in Europe* and *Value added taxation in Europe* published by the International Bureau of Fiscal Documentation

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CURRENT REVENUE

Tax revenue, before taking account of today's adjustments, is estimated at £5,254 million, or almost 12¼ per cent above the 1983 outturn. The estimate for non-tax revenue, which no longer includes Post Office revenue, is £627 million. This figure includes the contribution which I have already mentioned of £50 million by way of a special pre-payment of interest by Bord Telecom Eireann. Further returns will accrue in future years in respect of the massive State investment in telecommunications. No provision is made at this point for any receipts in 1984 from EMS subsidies, which in 1983 yielded some £44 million. The possibility of obtaining some revenue from a continuation of these subsidies in 1984 is being pursued.

Last year, some commentators considered that the Budget revenue forecasts were unduly conservative. In the event, however, revenue was marginally down on target. There is, as always, some uncertainty about the revenue forecast, which should be seen as a mid-point within a significant range and is heavily dependent on how the economy performs. I am hopeful, however, that this year, as in 1983, revenue will be reasonably close to the Budget forecast.

As I have already mentioned, the achievement of the Budget targets which the Government have set requires that there be some net increase in taxation. The increase proposed today is, in fact, the lowest for many years. This change in trend is a first step towards ultimately reducing the tax burden.

TAXATION

Medium-term policy

Before I deal with individual aspects of taxation, I want to summarise the Government's policy on taxation in the medium term.

The Government hope to receive a draft medium-term plan covering the years to 1987 from the National Planning Board by next April. Taxation must be an important element in any Government economic planning and I understand that the board will deal with this topic in some detail. The Government have already received the first report of the Commission on Taxation and this, together with the National Planning Board's views, will provide a most useful input into Government thinking on the subject.

It would be premature for me to anticipate what will be in the Government's medium-term plan on the subject of taxation but it would be desirable, I think, for me to sketch the path along which I feel tax reform should go.

The Commission on Taxation have listed three main criteria for a tax system, namely, simplicity, equity and efficiency. Our present tax arrangements can be faulted under all three headings and it must be the Government's priority in the years ahead to take progressive steps, as circumstances permit, to make the system simpler, more equitable and more efficient.

It is difficult to achieve and maintain simplicity in taxation. Since Government policy has multiple objectives and the tax system is a vehicle of Government policy, the system invariably becomes very complicated as allowances, deductions and exemptions of various kinds are grafted on – often, it must be said, for very good reasons. In our case, the result has been an erosion of the tax base which has in turn required steeply progressive income tax rates to raise the necessary revenue. In practice, because many taxpayers in the higher-income groups can reduce their tax liability by making full use of the deductions and reliefs, the degree of progressivity is less than the nominal rates would suggest. It would be desirable in the coming years to set ourselves the objective of restoring the tax base by progressively reducing or abolishing allowances, reliefs and deductions. It would also be desirable to extend the base by bringing within it certain receipts, accruing in money or in kind, which are now excluded.

This approach, which would permit progress towards a reduction of tax rates, is generally in line with that taken by the Commission on Taxation. I understand that the thinking of the National Planning Board is on similar lines.

Progress has been made in recent years towards making the tax system more equitable. It will continue to be the Government's objective to ensure that tax is levied fairly and equitably on all taxpayers. An important point to remember is that tax is only one element, although a very important one, in redistributing income. At least equally important is the redistributive effect of public expenditure. In examining the equity or inequity of policies, the tax system should not be judged in isolation from the composition of Government expenditure.

It is easy to be critical of specific tax measures and to point to anomalies. We should be equally critical in making assessments of expenditure programmes.

The tax system should also encourage the most efficient use of the economic resources of the community. It should strengthen the incentive to work, to save and to take risks.

There are undoubted conflicts between the three criteria of simplicity, equity and efficiency and these have to be reconciled at any given time. Care has also to be taken that changes do not cause individual hardship or that new anomalies do not emerge as a result.

At the end of the day the most important element is the total burden of taxation. Withdrawal of existing concessions for particular individuals or groups is much easier if the general level of taxation is being brought down. However desirable it might be to reduce taxation, this cannot be done on a significant scale, if at all, until current expenditure is reduced and the current Budget deficit eliminated.

This consideration also applies to the proposal for a single rate of tax made by the Commission on Taxation. I said last year that this was not a practical proposition at the time because the rate needed to sustain the direct tax yield would have to be at too high a level. A high single rate of tax would be unfair to less well-off taxpayers. I do not see a prospect of implementing this recommendation until it becomes possible to reduce the burden of taxation to a marked degree.

Income tax

Tax credits

I said last year that the introduction of income tax credits was being considered by the Government as a longer-term option. A changeover to credits is not, however, a practical option in the short-term because the resources required to cope with the administrative task involved are not available. Besides, the introduction of credits would be inequitable when income tax rates are high. The argument of credits is that they equalise the benefit of allowances and reliefs. However, many middle-income earners are now being taxed at high marginal rates and the introduction of tax credits would penalise these people at a time when their tax burden is already severe. I propose, therefore, to retain the existing income tax structure but I will keep the question of credits under review in the light of changing tax levels.

Reductions in income tax

Despite the Budget constraints, I believe it is desirable to provide now for some reductions in income tax. These must be inevitably be modest because of the necessity to sustain tax revenue.

The number of people paying tax at a marginal rate of 25 per cent has been decreasing as a result of the effectiveness of the exemption limits in catering for the lower-paid. I have therefore decided to eliminate the 25 per cent band and substantially widen the 35 per cent band to £4,000 for a single person and £8,000 for a married couple.

To ensure that taxpayers at all levels are more than compensated for these changes, I am increasing the personal allowance by £350 for a single person and £700 for a married couple. In addition, the widowed person's allowance and the one-parent family allowance will each be increased by £350. A widowed person with children will, therefore, be entitled to the same personal allowance as a married couple.

I am also improving the exemption limits for those on low incomes. The general exemption limit for single and widowed persons will be increased from £2,400 to £2,500 and from £4,800 to £5,000 for married couples. The age exemption limits are being increased from £2,500 to £2,800 for persons aged 65 years or over and from £3,000 to £3,300 for persons aged 75 years or over. These limits will be doubled for married couples. Marginal relief will continue for those whose income does not greatly exceed these amounts. These changes will remove about 15,000 low-income taxpayers from liability.

The changes in rate bands, allowances and exemption limits will cost £40 million in 1984 and £67 million in a full year. Given the relatively small amount of money available, I have ensured that the benefit in percentage terms is distributed as fairly as possibly while ensuring that the amount of tax paid by all taxpayers is reduced.

A special income tax allowance of £700 is available where a person is employed to take care of an incapacitated taxpayer or his spouse. This allowance is being increased to £2,000 at a cost of £150,000 in 1984 and £250,000 in a full year.

Renewal of PRSI tax allowance and 1 per cent levy

The special PRSI tax allowance and the temporary levy of 1 per cent on income are to be renewed for a further year. The estimated cost of renewing the PRSI tax allowance is £51 million in 1984, whereas the renewal of the temporary 1 per cent levy, on the existing basis, would yield £45 million this year.

The Government recognise, however, that the payment of the income levy is severe on those who are on low incomes, especially as the charge is based on gross income. The Government have therefore decided that from April onwards low-income persons will be exempted from payment of this levy. In the case of employees, the levy will not be payable in any week where income is less than £96. In the case of the self-employed, exemption will apply where income for the year is less than £5,000. The cost of this concession is estimated at £5 million in 1984 and £9 million in a full year. Approximately 350,000 persons will benefit.

Profit-sharing

In the 1982 Finance Act, a scheme was introduced to provide income tax exemption for shares given by companies to their employees under approved profit-sharing arrangements. This was intended to promote a greater involvement by workers in their employer companies and to aid industrial relations. To date the scheme has made only a small impact. This may be due to the restriction, of 20 per cent of profits, on the amount of expenditure under the scheme which companies may deduct in computing their profits for tax purposes and the ceiling of £1,000 on the value of shares allocated to an employee in any one year.

I will provide in the Finance Bill that the restriction on profits under the scheme will be removed and that the ceiling per employee be raised to £5,000.

Rent on private tenancies

In 1982 a scheme was introduced to provide income tax relief for rent paid in respect of private tenancies up to a maximum of £500 for single and £1,000 for married persons aged 65 years or over. With effect from the tax year 1984/85, the age threshold will be reduced to 60 years. This improvement will cost £600,000 in 1984 and £1 million in a full tax year. It is estimated that some 4,000 taxpayers will benefit.

Benefits-in-kind

I am concerned at the implications for tax yield of the growth of benefits-in-kind as a means of remuneration. Traditionally, such benefits were confined to cars and preferential loans. There is now a much wider and growing range of benefits and these are being introduced, in many instances, as an alternative to remuneration simply as a means of avoiding taxation. The present legislation on benefits-in-kind needs revision and it also needs to be extended to cover benefits which are not subject to tax at the present time. This is a complex issue because of the variety of benefits and I am having it examined in detail with a view to considering appropriate taxation provisions next year.

Taxation of self-employed

I said in the course of the Budget statement last year that I hoped to incorporate the necessary provisions in the 1984 Finance Bill with a view to having a current year basis of assessment of the self-employed in operation for the tax year 1984/85. I made it clear at the time that there could be no concessions involving a net loss of revenue as part of a changeover package.

On further examination of the problems associated with the introduction of a current assessment arrangement, I have reluctantly come to the conclusion that it is preferable to retain the existing system.

In the first place, the change would not produce additional revenue, in the short term at least, even if no concessions were granted. Furthermore, administrative work both for taxpayers and the Revenue would be significantly increased and assessments would obviously be less reliable and more open to challenge if they were based on necessarily tentative estimates of income in respect of a year which was not yet completed. I believe that a more effective return from the self-employed can be obtained by improving the present arrangements rather than introducing a new system which would be unreliable and would create further administrative complications for all concerned. The specified amount of tax payable by self-employed taxpayers who appeal an assessment is, therefore, being increased from 80 per cent to 85 per cent of the final amount due: this measure will relate to assessments made for the year 1984/85 and subsequent years. This is estimated to yield an extra £7 million in tax revenue this year.

Capital taxation

The general perception is that the yield from capital taxation in this country is low. In reality, if we take the internationally-accepted definition of capital taxes, which includes stamp duties and property taxes, the yield in 1983 was £193 million or about 4 per cent of total taxation. This is a substantial amount by any reasonable standard.

The yield in 1983 from capital acquisitions tax, capital gains tax and residential property tax was over £24 million. The corresponding pre-Budget estimate for this year is £23 million. This decline in yield does not reflect any reduction in the rates of capital taxation. Indeed, on the basis of the changes made in recent years, a substantially higher yield would in the normal course have been expected this year. The main explanation for the decline is the impact of the recession which has severely affected the number of capital transactions and eroded the capital tax base. Significant buoyancy cannot be expected under this heading until property and other markets recover from the recession. The recession has particularly affected the capital gains tax. I am, however, proposing a number of changes which will close some loopholes and increase the yield.

Capital gains tax

Up to now, capital gains tax has not been chargeable on receipts from the sale of a principal private residence. The exemption is reasonable, especially as the receipts are usually required for the purchase of another house. Where, however, a residence is sold for a significantly inflated price because of its development potential, it is appropriate that there should be a charge to tax. Capital gains tax will, therefore, apply in future to such receipts to the extent that they are deemed to exceed the current-use value of the property.

Capital acquisitions tax

The capital acquisitions tax provisions are very fragmented and there is need for a reorganisation. I propose to provide in the Finance Bill for a common table of tax rates ranging from 20 to 55 per cent and for aggregation of all gifts and inheritances. There will continue to be differing thresholds for different degrees of relationship. This rationalisation of the tax will yield £1 million this year and £4 million in a full year. The full details of the revised structure will be published in the Finance Bill.

Discretionary trusts

Last year I said that I was examining what tax measures might be required to ensure that discretionary trusts are not used as a vehicle for abuse. Having examined this matter I am proposing that, in respect of existing and new trusts, there will be a once-off charge of 3 per cent where the settlor is deceased and no beneficiary is under 25 years of age. This tax is directed at those trusts which are set up essentially to avoid tax or delay indefinitely the payment of capital acquisitions tax. However, there will be exemption in the case of trusts which provide for incapacitated persons or for public or charitable purposes. I estimate that the new tax will yield £1½ million in revenue this year.

Financial institutions

Building societies

I propose to alter the timing for payment by building societies of tax on interest and dividends paid by them to their investors. Instead of the tax on interest and dividends payable to investors in 1984 being due for payment in January 1985, one-half of that tax will be payable on October 1st, 1984, and the other half on April 1st, 1985, the normal grace period to apply in the case of both new dates. This will provide an estimated extra yield of £20 million this year. The composite rate for 1984/85 for all societies will remain at 75 per cent of the standard rate.

Bank levy and tax-based financing

I said last year that the bank levy would be phased out over the next few years. I also indicated that I would consider whether, in order to reduce the amount of tax lost to the Exchequer, tax-based financing might be restricted by limiting its scope in accordance with official industrial promotion policy. The levy will remain at £25 million for 1984. It will, however, be reviewed in future years in line with the increase in corporation tax payments from banks which will arise from the imposition of the following restrictions on tax-based financing.

With effect from today, new "section 84" lending and artificial preference share financing will not confer a tax advantage. In addition, accelerated capital allowances, that is, free depreciation and initial allowances, will not be allowed in respect of assets leased from today to customers by financial institutions, except where such new leasing forms part of a grant-aided incentive package by the State industrial promotion agencies. The overall amount of leasing will be maintained at about the present level sponsored by these agencies.

The Finance Bill will contain provisions to ensure that these measures are not circumvented by the transfer of tax-based leasing to the non-financial sector or by the undue continuation of existing "section 84" loan arrangements. The first significant impact on the tax yield from banks will not arise until 1985. There will be a smaller increase of about £7 million in the yield this year.

Insurance levy

The insurance levy will be retained this year, but in response to proposals from the industry, a variation in the method of charge in the case of life business will be provided for in the Finance Bill. The revised scheme will be the equivalent of the present scheme in terms of revenue yield.

Stamp duties

Cheques and credit cards

As regards stamp duties I am proposing that the duty on cheques be increased from 5p to 7p and that the duty on credit cards be increased from £5 to £10. These changes, which will take effect shortly, are estimated to yield an extra £2.7 million in 1984 and an extra £3.5 million in a full year.

Exemption for young trained farmers

The stamp duty exemption for transfer of land to young trained farmers is due to to be terminated in July. In recent months there has been a substantial interest in this concession and the indications are that it is proving worthwhile as an encouragement to early transfer of land. I am proposing therefore that the exemption be extended for one year.

Incentives

Long-term risk capital

Government strategies for industrial development will be outlined in the White Paper on Industrial Policy which is due for publication shortly. Meanwhile, I believe that specific tax encouragements are desirable in certain areas and and especially in relation to long-term risk capital. Such investment is urgently needed, particularly to support an expansion of activity in small manufacturing concerns, which have proved to be a valuable source of new employment.

I propose to allow income tax relief up to a specific ceiling each year for individuals who provide long-term risk capital for new manufacturing enterprises. The relief will be subject to suitable conditions as to the nature and minimum duration of the investment so as to ensure that it has the intended effect. The details will be incorporated in the Finance Bill.

Capital and other allowances

The deduction against profits for corporation tax purposes of £10 per week per additional employee will be renewed for a further year to end-June 1985. I will carry out an assessment of this incentive in the course of this year.

The 100 per cent initial allowance for plant and machinery and the 50 per cent initial and 4 per cent annual allowances for industrial buildings, due to expire at end-March 1984, will also be renewed for another year to end-March 1985. Laboratories used for analysis work connected with mining and oil exploration will qualify for the industrial buildings allowance.

The Finance Act, 1981, introduced certain allowances to encourage the investment of private sector funds in the construction of toll roads, including bridges, under agreements with local authorities, and multi-storey car parks for public use. In order to provide continued encouragement for construction activities, these allowances, which are due to expire on March 31st, 1984, will be continued for a further three-year period. The renewal of these various allowances will give rise to no cost in 1984.

Stock relief

The existing stock relief system was introduced in 1975 and is now in need of revision. The clawback provisions, in particular, have recently given rise to difficulties for traders suffering the effects of recession. Last year, I deferred for one year clawback which would have arisen for accounting periods ending in the year to April 5th, 1983, because of the potential adverse effect which payment would have had on firms. I propose to introduce from this year a new system under which relief will apply by reference to price increases only, no account being taken of volume changes. Thus, relief will be granted on the basis of the opening stock shown in the accounts. There will in general be no clawback of relief once granted. As regards relief given under the existing system, clawback deferred last year and any liability to clawback for later accounting periods will be waived, subject to safeguards against abuse of this concession which will be included in the Finance Bill. The relief will continue to apply to the same categories of traders as heretofore. In order to control cost, the amount of relief will be restricted to one-third of the price increase in the basic period. The cost to the Exchequer of the new system and the waiver of clawback will be of the order of £3 million in 1984.

Advance corporation tax

In the course of the Dail debates on the provisions for Advance Corporation Tax in the Finance Bill, 1983, I indicated that I would consider representations regarding this tax in the context of this year's Budget. Representations have been made to me by various affected interests seeking modification and even abolition of the tax. Having weighed carefully the factors involved, including the points made regarding the possible disincentive effects. I have concluded that the reasons underlying the incorporation of this measure in our tax regime remain decisive. Accordingly, Advance Corporation Tax will remain. In order, however, to ease further the implementation of the tax, I am extending the transitional period, within which ACT will be payable at 50 per cent of the full rate, to distributions made up to end-1984. After this the tax will be implemented in full. This relief will not entail a significant Exchequer cost in 1984, but will cost about £5 million in 1985.

Tax on petroleum development operations

Before I leave the subject of direct taxation, I would like to make a brief reference to taxation of petroleum development operations, the provisions for which were drawn up almost ten years ago. While this is not relevant in the context of today's Budget, it is of interest in the light of recent off-shore activity. The provisions to apply to the taxation of profits from petroleum production are being reviewed and I hope to be in a position soon to make a statement on this.

INDIRECT TAXATION

Value-Added Tax

Our indirect taxes have increased in recent years in line with the increase in overall tax revenue. Much of the increase has been concentrated on VAT, which has grown from 18 per cent of total tax revenue in 1980 to 25 per cent in 1983. While the main VAT rates are now rather high, it must be said that nearly half of the VAT base is zero-rated or liable at the 5 per cent rate. If VAT were applied equally to all goods and services, the main rates could come down quite dramatically. We cannot maintain a zero or low rate on such a wide range of items without having to impose relatively high rates on other items.

For the longer term, I will be looking at the possibility of a fundamental re-organisation of the VAT structure, with the aim of narrowing the disparity in the rates charged on the bulk of goods and services. I expect that the Commission on Taxation Report on Indirect Taxes, which should be completed soon, will be useful in this review.

Because of our Budgetary difficulties, we obviously cannot envisage a reduction in overall VAT revenue at this time. I propose to make the following changes in VAT, involving both increases and reductions.

VAT at 8 per cent will be applied to clothing from May 1st, 1984. However, clothing for children up to the age of approximately ten years will be excluded and will continue to be zero-rated. This measure will widen the tax base and help towards a more rational distribution of the burden of VAT. It will yield £16½ million in 1984 and £29 million in a full year. I have excluded all footwear from the increase.

VAT on theatres and other live performances will be reduced to 5 per cent from March 1st, 1984.

I propose to reduce the rate of VAT on the short-term hire of cars, caravans and boats to 18 per cent from March 1st, 1984. This brings the VAT on these services which are predominantly tourist-oriented, into line with that on hotel accommodation.

As a further measure to boost tourism, I propose to introduce a scheme to allow the refund of VAT on goods bought here at retail level by visitors and exported in their personal baggage. Details of the scheme will be announced at a later date. It will operate from March 1st, 1984.

VAT on concrete will be reduced to 5 per cent from March 1st, 1984. This reduction will not apply to concrete products.

These VAT concessions will cost £3.6 million in 1984 and £4.5 million in a full year.

Excise duties

Traditionally, excise duty increases have been a significant source of additional tax revenue in the Budget. On this occasion the scope for increases is severely limited. The evidence suggests that we may be near the point of diminishing returns in some areas. This is due partly to price discrepancies on some excisable goods between here and Northern Ireland, which encourage smuggling and legitimate imports by travellers. It is wrong, however, to identify the high level of tax as the sole reason for the drop in consumption. While the level of tax is a contributory factor, the main problem is the continuing recession.

I am satisfied nevertheless that some modest increases can still be applied. These are necessary to bring in extra tax revenue. The changes are generally below the rate of inflation and consequently it is reasonable to expect that they will have little effect on consumption or domestic purchases. In fact, since the excise duties are largely specific rather than ad valorem, the real level of excise duty will generally be less in 1984 than in 1983.

Increases in excise duties

The increases proposed are as follows, including consequential VAT:

Beer – 2p per pint.

Wine – 8p per bottle of table wine, with *pro rata* increases for stronger wines.

Cider and Perry – 10p per gallon on the ordinary strength cider and perry, with greater increases for stronger cider and perry.

Cigarettes – 10p on the packet of 20 cigarettes in the most popular price category, with *pro rata* increases for cigars and other tobacco products.

Petrol – 6p per gallon, but existing rebates to handicapped drivers will be increased to match this duty increase.

Auto-diesel – 6p per gallon, but this will not apply to scheduled road passenger services.

Auto-LPG – 6p per gallon.

I am not proposing any increase in the duty on spirits.

The yield from these increases is estimated at £47.3 million in 1984 and £54.9 million in a full year.

The excise duty increases will take effect from midnight tonight, but increases in retail prices must await new maximum price orders where appropriate. These will be made by the Minister for Industry, Trade, Commerce and Tourism, who will determine the appropriate implementation date. Even where price control does not operate, there should be no increase in the price of goods already in the shops, as the excise duty will apply only to goods imported or removed from bond from midnight tonight.

There are also some concessions I wish to make in the excise area.

Wine

A deferment of the duty on wine will be allowed up to the 15th day of the following month, subject to a catch-up in December. This will apply from March 1st next and will bring the position into line with that on other drinks where deferment already applies. With the catch-up provision, there will be no loss of tax revenue involved.

Beer used in table water

I propose that, where beer is used in the manufacture of table waters, such as shandy, the excise duty paid on such beer will be repaid, with effect from March 1st, 1984. The final product will continue to be liable to table waters duty in the normal way. This will place the home-produced product on an equal footing with imports.

Residual fuel oil

The excise duty on residual fuel oil, other than that used by the ESB, was reduced to 4½p per gallon in December, 1981. In order to moderate industrial costs, a further reduction of 1p is being made with immediate effect.

Avgas

Avgas is used in some light aircraft and at present is liable to petrol duty. It competes with fuels which are much less heavily taxed and the differential causes competitive problems for some operators. I consider that a reduction in duty to 50 per cent of the petrol duty is warranted and an appropriate provision will be included in the Finance Bill.

Foreign travel tax

I propose to remove the foreign travel tax from tickets issued in respect of groups of children travelling abroad on educational trips. This will apply from April 1st, 1984.

The scope of the tax will be extended to tickets sent from abroad to Irish residents for journeys commencing in the State. This is intended to reduce the possibility of avoiding the tax.

These excise duty concessions will reduce revenue by about £1.3 million in 1984 and £1.5 million in a full year.

Before I leave the excise duties, there are a few other points I would like to mention.

From January 1st, 1985, the restrictions which we have been allowed to maintain on importations of motor vehicles since our entry into the EEC will no longer apply. This does not mean that there will be any reduction in the level of excise duty on motor vehicles.

While I am having the taxation regime for motor vehicles examined at present to see whether any changes would be desirable to meet the new circumstances, the intention will be to maintain the existing overall level of taxation in this area.

As regards smuggling, and evasion of indirect taxes generally, I am examining proposals with a view to achieving better enforcement of existing legislative provisions and I am looking at proposals which may require changes in legislation. The penalties for evasion have been increased significantly in recent years, but I am reviewing these also.

Road tax

Finally, in relation to indirect taxes, I am proposing that the annual rates of road tax on private cars be increased by £1 per unit of horsepower with effect from March 1st. This will yield additional revenue of £6.5 million in 1984.

EVASION AND TAX AVOIDANCE

Last year I announced a series of new measures to deal with tax evasion. Those that required statutory authority were subsequently incorporated in the Finance Act and the other measures were given effect through administrative change. It is too early to make an assessment of results because, of their nature, some of the changes will not have a substantial effect for some time ahead.

The widespread public reaction, however, is an indication of the potential impact of these measures in countering evasion. I can assure the House that they will be implemented vigorously. I intend to pay special attention in the coming year to making improvements in collection procedures which should help considerably in catching up with tax evaders.

I mentioned in the 1983 Budget Statement that I was reviewing the reporting arrangements for payments to individuals and companies by Government Departments and public authorities to ensure that relevant details would be made available to the Revenue Commissioners.

One result of this review is that details of public sector contracts are now being provided to the Commissioners, and I am examining the feasibility of requiring the production by firms of a tax clearance certificate as a condition of obtaining such contracts.

Bond-washing

Provision will be made in the Finance Bill to counter the practice known as bond-washing whereby securities change hands in a manner designed to ensure that the interest accrues to the holder as a tax-exempt capital gain rather than as income. In respect of sales or transfers of securities made after today, that part of the gain on securities which is attributable to the value of the interest to be paid will be treated as part of the seller's income for the purposes of the Taxes Acts.

Short-dated securities

Provision will also be made in the Finance Bill to withdraw the tax exemption provided in existing law in relation to gains made on Exchequer Bills or other similar non-interest-bearing securities. The new provisions will apply to issues of such securities made after today.

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UNITED KINGDOM:

Budget 1984-85

Two targets: further reduction of inflation and start of a tax reform

Extracts from the Budget Speech 1984-85 pronounced by Mr. Nigel Lawson, Chancellor of the Exchequer, on 13 March 1984.

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TWO THEMES

My Budget today has two themes.

First, the further reduction of inflation. And second, a series of tax reforms designed to enable the economy to work better. Reforms to stimulate enterprise and set British business on the road to profitable expansion. Reforms that will help to bring new jobs.

I shall begin by reviewing the economic background to the Budget. I shall then deal with the Medium Term Financial Strategy; with monetary policy and the monetary targets for next year; and with public borrowing and with the appropriate public sector borrowing requirements for the coming year. I shall then turn to public expenditure, including the prospects for the longer term.

Finally, I shall deal with taxation, and the changes in the structure of taxation which will pave the way for cuts in taxes in subsequent years, for this will be a tax reform Budget.

As usual, a number of press releases, filling out the details of my tax proposals, will be available from the Vote Office as soon as I have sat down.

Ecomomic background

I start with the economic background.

Since 1980, inflation has fallen steadily from a peak of over 20 per cent. For last year as a whole it was down to about 4½ per cent, the lowest figure since the sixties. And with lower inflation have come lower interest rates.

This in turn has led to an economic recovery whose underlying strength is now beyond dispute. Whereas in some previous cycles recovery has come from a self-defeating stimulus to monetary demand, this time it has sprung from sound finance and honest money. Lower inflation and lower interest rates benefit industry, business and consumer confidence alike.

Across the economy, total money incomes grew in 1983 by about 8 per cent, of which 3 per cent represented real growth in output. Although there is still room for improvement, this is a very much healthier division between inflation and real growth than the nation experienced in the 1970s. Output in the second half of 1983 is now reckoned to have exceeded the previous peak, before the world recession set in, and is still rising strongly.

Productivity too has continued to improve rapidly. Just as over the past year many have wrongly predicted an end to the recovery, so some have tried to dismiss the sharp rise in productivity as a flash in the pan. Yet in 1983 manufacturing productivity grew by 6 per cent for the second year in succession. Unit labour costs across the whole economy are likely to show the smallest annual increase since the 1960s. This has allowed a welcome and necessary recovery in real levels of profitability.

Higher profits lead to more jobs. The number of people in work increased by about 80,000 between March and September last year. The loss of jobs in manufacturing has slowed down sharply, while jobs in services increased by getting on for 200,000 in the first nine months of last year.

But further progress is needed. Although our unit wage costs in manufacturing rose by under 3 per cent last year, our three biggest competitors, the U.S., Japan and West Germany, did better. The employment prospect would be significantly improved if a bigger contribution to improved cost performance were to come from lower pay rises.

Demand, output, profits and employment all rose last year. Home demand has played the major part in the recovery so far. Lower inflation reduced people's need to save, and real incomes rose. Personal consumption increased by over 3½ per cent compared with 1982.

Fixed investment rose rather faster than consumption, with investment in housing and services particularly strong.

Our rate of economic growth last year was the highest in the European Community. For much of 1983 our export performance was affected by weak demand in many of our overseas markets, while imports rose slightly faster than home demand. But by the end of last year world trade was clearly moving ahead again, and in the three months to January manufacturing exports increased very substantially. The balance of payments on current account last year is estimated to have been in surplus by about £2bn.

Our critics have been confounded by this combination of economic recovery and low inflation. Even the pessimists have been forced to acknowledge the durability of the recovery.

It is set to continue throughout this year at an annual rate of 3 per cent. Inflation is expected to remain low, edging back down to 4½ per cent by the end of this year. With rising incomes and low inflation, consumption will continue to grow. And, encouraged by improved profitability and better long-term growth prospects , investment is expected to rise by a good 6 per cent this year.

Looking abroad, too, economic prospects are more favourable than for some time. Output in the U.S. should continue to grow strongly this year. And recovery is spreading to the rest of the world.

Of course, there are inevitable risks and uncertainties. The size and continued growth of the U.S. budget deficit is a cause of widespread concern and keeps interest rates high, exacerbating the problems of the debtor countries.

And the need to finance the U.S. deficit by inflows of foreign capital has kept the dollar artificially high and led to a massive and growing trade deficit, greatly increasing the pressures for protectionism within the U.S.

A second potential risk is disruption in the oil market. The UK and indeed the world economy, inevitably remain vulnerable to any major disturbances in this market.

But despite these risks there is a growing sense throughout the industrialised world that the recovery this time is one which can be sustained. The essential requirement is the continued pursuit of prudent monetary and fiscal policies.

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Tax reform

I indicated at the outset that this will be a radical, tax-reforming Budget. It will also significantly reduce the overall burden of tax over the next two years taken together. And I hope to have scope for further reductions in future Budgets.

My proposals for reform are guided by two basic principles. First, the need to make changes that will improve our economic performance over the longer term. Second, the desire to make life a little simpler for the taxpayer.

But I am well aware that the tax reformer's path is a stony one. Any change in the system is bound at least in the short term, to bring benefits to some and disadvantages to others.

And the disapproval of the latter group tends to be rather more audible than the murmurings of satisfaction from the former.

Some commentators have suggested that our entire income-based tax system should be replaced with an expenditure-based system. Even if a root-and-branch change of this kind were desirable, it would, I believe, be wholly impractical and unrealistic.

But I do not believe we can afford to opt for the quiet life and do nothing. So I have chosen the middle way – to introduce reforms, some of them far-reaching, within the framework of our existing income-based system. I shall also be proposing transitional arrangements where I believe it fair and appropriate to do so.

The changes I shall be proposing today fall into three broad categories. These are the taxation of savings and investment, business taxation, and the taxation of personal income and spending.

Savings

First, the taxation of savings and investment. The proposals I am about to make should improve the direction and quality of both. And they will contribute further to the creation of a property-owning and share-owning democracy, in which more decisions are made by individuals rather than by institutions.

I start with stamp duty. This was doubled from its long-standing 1 per cent by the post-war Labour Government in 1947, reduced by the Conservative Government in 1963, and once again doubled to 2 per cent by Labour in the first Budget presented by the Rt. Hon Member for Leeds East in 1974. At its present level it is an impediment to mobility and incompatible with the forces of competition now at work in the City, following the withdrawal of the Stock Exchange case from the Restrictive Practices Court.

I therefore propose to halve the rate of stamp duty to 1 per cent. The new rate will apply straight away to Stock Exchange deals. It will also apply from today to other transactions where documents are stamped on or after March 20.

For the home buyer, the new flat rate 1 per cent stamp duty will start at £30,000. Below this level no duty will be payable. As a result of this £5,000 increase in the threshold, 90 per cent of first-time home buyers will not have to pay stamp duty at all.

Reducing the rate of duty on share transfers will remove an important disincentive to investment in equities and increase the international competitiveness of our stock market. It should also help British companies to raise equity finance.

In addition, I have four proposals to encourage the issue of corporate bonds. I shall go ahead with the new arrangements for deep discount stock and the reliefs for companies issuing Eurobonds, and for convertible loan stock, which were announced but not enacted last year. And I propose to exempt from capital gains tax most corporate fixed interest securities provided they are held for more than a year. Since such securities are already exempt from stamp duty this means that the tax concessions for private sector borrowing in the corporate bond markjet will now be virtually the same as for Government borrowing in the gilt-edged market.

The reduction in stamp duty will cost £450m in 1984-85, of which £160m is the cost of the relief on share transfers, and £290m the cost of the relief on transfers of houses and other buildings and land.

Life assurance

Next, life assurance. The main effect of life assurance premium relief today is unduly to favour institutional rather than direct investment. It has also spawned a multiplicity of well-advertised tax management schemes, and no less than 50 pages of legislation attempting to deal with its abuse. I therefore propose to withdraw the relief on all new contracts made after today. I stress that this change will apply only to new (or newly-enhanced) policies taken out after today. Existing policies will not be affected at all. The change is estimated to yield about £90m in 1984-85.

I am also proposing to curtail the special – but unfortunately widely abused – privileges for what are known as "tax exempt" friendly societies and bring them into line with the normal rules for friendly societies doing "mixed" business. However, the limits within which in future all friendly societies will be able to write assurance on a tax exempt basis will be increased from £500 to £750.

Investment income surcharge

I have also reviewed the tax treatment of direct personal investment. The investment income surcharge is an unfair and anomalous tax on savings and on the rewards of successful enterprise. It hits the small businessman who reaches retirement without the cushion of any company pension scheme, and impedes the creation of farm tenancies. In the vast majority of cases it is a tax on savings made out of hard-earned and fully-taxed income. More than half of those who pay the investment income surcharge are over 65, and of these half would otherwise be liable to tax at only the basic rate.

I have therefore decided that the investment income surcharge should be abolished. The cost in 1984-85 will be some £25m, building up to around £350m in a full year.

Finally, I propose to draw more closely together the tax treatment of depositors in banks and building societies.

These institutions compete in the same market for personal deposits. I believe that they should be able to do so on more equal terms as far as tax is concerned. One source of unequal treatment has already been removed, with the recent change made on legal advice in the tax treatment of building societies' profits from gilt-edged securities. They are now treated in the same way as those of the banks have always been.

But the major source of unequal treatment, against which the banks in particular have frequently complained, is the special arrangement for interest paid by building societies. The societies pay tax at a special rate – the "composite rate" – on the interest paid to the depositor, who receives credit for income tax at the full basic rate.

This system, which has worked well for the past 90 years, has both an advantage and disadvantage. The disadvantage is that a minority of depositors, who are below the income tax threshold, still pay tax at the composite rate. It has not, however, stopped many of them using building societies because of the competitive rates they have offered. The advantage of the scheme is its extreme simplicity, particularly for the taxpayer; most taxpayers are spared the bother of paying tax on interest through PAYE or individual assessment, while the Revenue are spared the need to recruit up to 2,000 extra staff to collect the tax due on interest paid without deduction.

In common with my predecessors of all parties over the past 90 years, I am satisfied that the advantage of the composite rate arrangement outweighs the disadvantage.

It follows that equal treatment of building societies and banks should be achieved, not by removing the composite rate from the societies, but by extending it to the banks and other licensed deposit takers.

Non-taxpayers will continue to be able to receive interest gross, should they wish to do so, by putting their money into appropriate National Savings facilities. But the purpose of the move is not, of course, to attract savings into Government hands: as I have already announced, next year's target for National Savings will be the same as this year's and last year's; and the total Government appetite for savings, which is measured by the size of the Public Sector Borrowing Requirement, is being significantly reduced.

The true purpose of the move is simple: fairer competition and simplicity itself. The great majority of individual bank customers will, when it comes to tax, be able to forget about bank interest altogether, for all the tax due on it will already have been paid. And it will be easier for people to compare the terms offered for their savings by banks and building societies.

The purpose of the change is not to raise additional revenue. The composite rate arrangement is designed to collect no more tax than would be due at the basic rate from all depositors under existing arrangements.

However, the Inland Revenue will be able to make staff savings of up to 1,000 civil servants. Moreover, this figure takes no account of the substantial numbers of additional Inland Revenue staff who would have been required to operate the present system as the trend towards the payment of interest on current accounts develops.

Accordingly, I propose to extend the composite rate arrangements to interest received by UK resident individuals from banks and other licensed deposit-takers with effect from 1985-86. The composite rate will not apply either to non-residents or to the corporate sector. Arrangements will also be made to exclude from the scheme certificates of deposit and time deposits of £50,000 or more.

Taken together, the major proposals I have just announced on stamp duty, life assurance premium relief, the investment income surcharge, and the composite rate, coupled with other minor proposals, will provide a simpler and more straightforward tax system for savings and investment. They will remove biases which have discouraged the individual saver from investing directly in industry.

They will reinforce the Government's policy of encouraging competition in the financial sector, as in the economy as a whole. And they are part of a package of measures designed to enable interest rates to fall and reduce the cost of borrowing.

Business taxation

I now turn to business taxation. Here, government has two responsibilities towards British business and industry. The first is to ensure that they do not have to bear an excessive burden of taxation. The second is to ensure that, given a particular burden, it is structured in the way that does least damage to the nation's economic performance.

The measures I am announcing today will, taking the next two years together, result in a substantial reduction in the burden of taxation on British business. And in addition I shall be proposing a far-reaching reform of company taxation.

Responses to the Corporation Tax Green Paper in 1982 showed a strong general desire to retain the imputation system. I accept that. But other changes are needed.

The current rates of corporation tax are far too high, penalising profit and success, and blunting the cutting edge of enterprise. They are the product of too many special reliefs, indiscriminately applied and of diminishing relevance to the conditions of today. Some of these reliefs reflect economic priorities or circumstances which have long vanished and now serve only to distort investment decisions and choices about finance. Others were introduced to meet short-term pressures, notably the upward surge of inflation.

With inflation down to today's low levels, this is clearly the time to ask a fresh look. And with unemployment as high as it is today, it is particularly difficult to justify a tax system which encourages low-yielding or even loss-making investment at the expense of jobs.

My purpose therefore is to phase out some unnecessary reliefs, in order to bring about, over time, a markedly lower rate of tax on company profits.

Phase out of reliefs

First, capital allowances. Over virtually the whole of the post-war period there have been incentives for investment in both plant and machinery and industrial (though not commercial) buildings. But there is little evidence that these incentives have strengthened the economy or improved the quality of investment. Quite the contrary: the evidence suggests that businesses have invested substantially in assets yielding a lower rate of return than the investment made by our principal competitors. Too much of British investment has been made because the tax allowances make it look profitable, rather than because it would be truly productive. We need investment decisions based on future market assessments, not future tax assessments.

I propose to restructure the capital allowances in three annual stages. In the case of plant and machinery, and assets whose allowances are linked with them, the first-year allowance will be reduced from 100 per cent to 75 per cent for all such expenditure incurred after today, and to 50 per cent for expenditure incurred after March 31 next year. After March 31, 1986 there will no first-year allowances, and all expenditure on plant and machinery will qualify for annual allowances on a 25 per cent reducing balance basis.

In addition, from next year annual allowances will be given as soon as the expenditure is incurred, and not, as they are today, when the asset comes into use.

This will bring forward the entitlement to annual allowances for those assets, such as ships and oil rigs, for which some payment is normally made well before they are brought into use.

For industrial buildings, I propose that the initial allowance should fall from 75 per cent to 50 per cent from tonight, and be further reduced to 25 per cent from March 31 next year. After March 31, 1986 the initial allowance will be abolished, and expenditure will be written off on an annual 4 per cent straight line basis.

When these changes have all taken place, tax allowances for both plant and machinery and industrial buildings will still on average be rather more generous than would be provided by a strict system of commercial depreciation.

Development areas

The changes in the rates of allowances will not apply to payments under binding contracts entered into before midnight tonight, provided that the expenditure is incurred within the next three years.

There will be transitional tax arrangements for certain investment projects in the development areas and special development areas. When a project in those areas has had an offer of Industry Act selective financial assistance and also attracts regional development grants, the existing capital allowances will continue to apply to the expenditure to which the selective assistance is related. These arrangements will cover projects for which offers have already been made between April 1 1980 and today. Similar arrangements for regional development grants were announced by my Rt. Hon. Friend the Secretary of State for Trade and Industry in his White Paper last December.

Over the same period to March 31, 1986, most other capital allowances will be brought into line with the main changes I have announced. The Inland Revenue will be issuing a Press notice tonight giving full details of these proposals.

Stock relief

Next, stock relief. As the House will recall, this was introduced by the last Labour Government as a form of emergency help to businesses facing the ravages of high inflation. Those days are past; and the relief is no longer necessary. Company liquidity has improved and, above all, inflation has fallen sharply. Accordingly, I propose not to allow stock relief for increases in prices after this month.

Reduction of corporation tax rate

The changes I have just announced, in capital allowances and stock relief, enable me to embark on a major programme of progressive reductions in the main rate of Corporation Tax.

For profits earned in the year just ending, on which tax is generally payable in 1984-85, the rate will be cut from 52 per cent to 50 per cent. For profits earned in 1984-85 the rate will be further cut to 45 per cent. Looking further ahead, to profits earned in 1985-86, the rate will go down to 40 per cent; and for profits earned in 1986-87 the main rate of corporation tax will be 35 per cent – no less than 17 percentage points below the current rate.

All these rates for the years ahead will be included in this year's Financial Bill. And when these changes are complete, our rates of capital allowances for the generality of plant and machinery will be comparable with those in most other countries , while the rate of tax on profits will be significantly lower.

The substantial reduction in the rate of corporation tax will bring a further benefit. Our imputation system allows a company to offset in full all interest paid.

But only a partial offset for dividends is allowed. Companies thus have a clear incentive to finance themselves through borrowing, in particular bank borrowing, rather than by raising equity capital. The closer the corporation tax rate comes to the basic rate of income tax, the smaller this undesirable distortion becomes.

Of course, the majority of companies are not liable to pay the main rate of corporation tax at all. For them it is the small companies' rate, at present 38 per cent, which applies. I propose to reduce this rate forthwith to 30 per cent, for profits earned in 1983-84 and thereafter. A tax regime for small companies which is already generous by international standards will thus become markedly more generous.

The Corporation Tax measures I have just announced will cost £280m in 1984-85. In 1985-86 the cost will be £450m – made up of £1,100m by way of reductions in the rates, only partially offset by a £650m reduction in the value of the reliefs. During the transitional period as a whole, these measures should have a broadly neutral effect on the financial position of companies. But when the changes have fully worked through, companies will enjoy very substantial reductions in the tax they pay.

Business and industry can go ahead confidently on the basis of the Corporation Tax rates I have announced today, which set the framework of company taxation for the rest of this Parliament.

Over the next two years, these changes will cause some investment to be brought forward, to take advantage of high first year capital allowances – a prospect made all the more alluring for business since the profits earned will be taxed at the new, lower, rates. But the more important and lasting effect will be to encourage the search for investment projects with a genuinely worthwhile return, and to discourage uneconomic investment.

It is doubtful whether it was ever really sensible to subsidise capital investment irrespective of the true rate of return. Certainly, with over 3m unemployed it cannot make sense to subsidise capital so heavily at the expense of labour.

These changes hold out an exciting opportunity for British industry as a whole – an opportunity further to improve its profitability, and to expand, building on the recovery that is already well under way. Higher profits after tax will encourage and reward enterprise, stimulate innovation in all its forms, and create more jobs.

I now turn to some more detailed measures affecting business.

Business expansion scheme

The Business Expansion Scheme, introduced last year as a successor to the Business Start Up Scheme has been widely welcomed as a highly imaginative scheme for encouraging individuals to invest in small companies. It is already proving a considerable success. It now needs time to settle down, and I have only one change to propose this year.

The scheme was designed to offer generous incentives for investment by new or expanding companies in high risk areas. The ownership of farmland cannot be said to fall within this category, and I therefore propose that from tomorrow farming should cease to be treated as a qualifying trade under the scheme.

Next, in keeping with what I have said about removing complexity and distortions, I propose to abolish two reliefs in the personal tax field which were introduced at a time when this country suffered from excessively high rates of income tax. As we have reduced those rates, the reliefs are no longer justified.

Foreign-domiciled employees

The first is the 50 per cent tax relief (falling after nine years to 25 per cent) applied to the emoluments of foreign-domiciled employees working here for foreign employers. These employees are often paying much less tax here than they would either in their own country or in most other European countries. At present income tax rates, the need for this relief has clearly disappeared. Moreover, it is open to widespread abuse. It is, for example, possible for someone whose parents came here from abroad and who has himself lived here all his life to enjoy this relief, if he works for a foreign company. That cannot be right.

I therefore propose to withdraw the relief for all new cases from today. For existing beneficiaries, the 25 per cent relief will cease on April 6, and the 50 per cent relief will be phased out over the next five years.

Foreign earnings relief

I also propose to withdraw the foreign earnings relief for United Kingdom residents who work at least 30 days abroad in a tax year. This relief too harks back to the days of penally high income tax rates. It too has been exploited, in particular by those who prolong their overseas visits purely in order to gain a tax advantage. I propose to withdraw the matching relief for the self-employed, who spend 30 days abroad and for those resident in the UK who have separate employments or separate trades carried on wholly abroad. The relief will be halved to 12½ per cent in 1984-85 and removed entirely from April 6 1985.

However, I am not making any change to the 100 per cent deduction given for absences abroad of 365 days or more. In addition, I have authorised consultations by the Inland Revenue about a possible relaxation in the rules governing the taxation of expenses reimbursed to employees for travel overseas.

The abolition of these reliefs will eventually yield revenue savings of over £150m; and represents another useful step in the removal of complexity and distortions in the tax system.

Car benefits

I need to set the car benefit scales for 1985-86 for those provided with the use of a car by their employer. Despite the increases over recent years, the levels still fall short of any realistic measure of the true benefit. I am proposing an increase of 10 per cent in both car and car fuel scales with effect from April 1985.

Capital taxes

Unnecessarily high rates of tax discourage enterprise and risk taking. This is true of the capital taxes, just as it is of the corporation and income taxes. It is a matter of particular concern to those involved in running unquoted family businesses. The highest rates of capital transfer tax are far too high and badly out of line with comparable rates abroad. I propose there fore, in addition to statutory indexation, to reduce the highest rate of capital transfer tax from 75 per cent to 60 per cent. For lifetime gifts I propose to simplify the scale so that the rate is always one-half of that on death.

For capital gains tax I will, as promised, bring forward in the Finance Bill proposals to double the limit for retirement relief to a figure of 100,000 backdated to April 1983. A consultative document on other possible changes in this relief is being issued next week.

I am proposing no other changes this year in capital gains tax beyond the statutory indexation of the exempt amount from £5,300 to £5,600. However, the tax continues to attract criticism – not least for its complexity – and that is a matter to which I hope to return next year.

We have done much to improve the development land tax. Early in the last Parliament, my predecessor increased the threshold from £10,000 to £50,000. I now propose a further increase to £75,000, which will reduce the number of cases liable to the tax by more than one-third.

Share options

Next share options. The measures introduced in the last Parliament to improve employee involvement through profit-sharing and savings-related share options schemes have been a notable success. The number of these schemes open to all employees has increased from about 30 in 1979 to over 670 now. Benefiting some 0.5m employees.

To maintain and build on this progress I propose to increase the monthly limit on contributions to savings-related share option schemes from £50 to £100. I have also authorised the Inland Revenue to double the tax-free limits under the concession on long service awards, and to include within these limits the gift of shares in the employee's company.

But beyond this, I am convinced that we need to do more to attract top calibre company management and to increase the incentives and motivation of existing executives and key personnel by linking their rewards to performance. I propose therefore that, subject to certain necessary limits and conditions, share options generally be taken out of income tax altogether, leaving any gain to be charged to capital gains tax on ultimate disposal of the shares. The new rules will apply to options meeting the necessary conditions which are granted from April 6.

I am sure that all these changes will be welcomed as measures to encourage the commitment of employees to the success of their companies and to improve the performance, competitiveness and profitability of British industry.

U.S. unitary tax

As the House knows, the Government is deeply concerned at the threat which the spread of unitary taxation in certain U.S. states has posed to the U.S. subsidiaries of British firms. With our European partners we are monitoring the situation closely and await with keen interest the imminent report of U.S. Treasury Secretary Regan's working group. It is essential that a satisfactory solution is found and speedily implemented. U.S. firms operating in this country are not of course taxed on a unitary basis.

Oil taxation

I now turn to oil taxation. Last year's North Sea tax changes were well received, and there has been a substantial increase in the number of development projects coming forward, and a new surge in exploration. Work on no fewer than 128 offshore exploration and appraisal wells started last year – an all-time record.

The Government is already committed to a study of the economics of investment in incremental development in existing fields. This is of increasing importance, and in consultation with my Rt. Hon. Friend, the Secretary of State for Energy, I therefore propose to review this area with the industry, and to legislate as appropriate next year to improve the position. To prevent projects being deferred pending this review, any changes will apply to all projects which receive development consent after today.

Meanwhile, I am taking two measures to prevent an unjustified loss of tax in the North Sea. First, in addition to the PRT measures on farmouts which I announced last September, I am limiting the potential corporation tax cost of such deals. Second, I propose to repeal the provision which allows advance corporation tax to be repaid where corporation tax is reduced by PRT. I have also reviewed the case for extending last year's future field concessions to the Southern Basin, but have concluded that additional incentives here are not needed.

I have just two further changes affecting business to propose, both of which will come into force on October 1.

VAT on imported goods

Ever since value-added tax was introduced in this country, we have treated imports differently from the way our main European Community competitors treat them.

While they require VAT on imported goods to be paid in the same way as customs duties, we do not. Under our system an importer does not have to account for VAT on his imports until he makes his normal VAT return, on average some 11 weeks later. During this time the importer enjoys free credit at the taxpayer's expense. But when one British businessman buys from another, he gets no such help from the taxpayer: he pays his VAT when he pays his supplier.

The European Commission has for some years now been seeking, with our full support, to get a system like ours adopted throughout the Community. But the plain fact is that in all that time the Commission has made no progress whatever.

I must tell the House that I am not prepared to put British industry at a competitive disadvantage in the home market any longer.

Should our European partners at any time undergo a Damascene conversion, and agree that the Commission's proposal should be accepted after all, then of course we would revert to the present system. But in the meantime I propose to move to the system used by our European competitors. We shall provide the same facilities for payment of VAT on imports as apply to customs duties. That means that most importers will be able to defer payment of VAT by on average one month from the date of importation. But that is all.

As I have said, this change will apply from October 1. By bringing forward VAT receipts, it will bring in an extra £1.2bn in 1984-85, some of which will be borne by foreign producers and manufacturers. There will of course be no increased revenue in subsequent years.

National insurance surcharge

The second change I propose to make on October 1 concerns the National Insurance Surcharge.

This tax on jobs was introduced by the Labour Government in 1977 at the rate of 2 per cent, and further increased by the Rt Hon Member for Leeds East in 1978 to 3½ per cent. During the last parliament, this Government reduced it to 1 per cent, and we are pledged to abolish it during the lifetime of this parliament.

Given the impact that this tax has, not only on industrial costs but also – at a time of high unemployment – on jobs, I have decided to take the opportunity of this my first Budget to fulfil that pledge. Abolition of the National Insurance Surcharge from October will reduce private sector employers' costs by almost £350m in 1984-85, and over £850m in a full year. It will thus be of continuing help to British industry. As before, the benefit will be confined to the private sector.

The House will, I am sure, agree that a Budget which substantially reduces the Government's demands on the financial system which abolishes the National Insurance Surcharge, and which cuts the rates and simplifies the structure of corporation tax, is a Budget for jobs and for enterprise. It offers British industry an opportunity which I am confident it will seize.

Personal income and spending

Having announced major reforms of both the taxation of savings and investment and the taxation of business, I turn now to the third and final area in which I propose to make progress on tax reform. This is the taxation of personal income and spending.

The broad principle was clearly set out in the Manifesto on which we were first elected in 1979. This emphasised the need for a switch from taxes on earnings to taxes on spending. My predecessor made an important move in this direction in his first Budget, and the time has come to make a further move today. To reduce direct taxation by this means is important in two ways. It improves incentives and makes it more worthwhile to work, and it increases the freedom of choice of the individual.

Having regard to the representations I have received on health grounds, I therefore propose an increase in the tobacco duty which, including VAT, will put 10p on the price of a packet of cigarettes, with corresponding increases for hand-rolling tobacco and cigars. This will do no more than restore the tax on tobacco to its 1965 level in real terms. These changes will take effect from midnight on Thursday. I do not, however, propose any increase in the duty on pipe tobacco.

I propose to raise most of the other excise duties broadly in line with inflation, so as to maintain their real value; not to do so would run counter to the philosophy I outlined a moment ago. But with inflation as low as it now is, the necessary increases are on the whole mercifully modest.

I propose to increase the duties on petrol and Derv by amounts which, including VAT, will raise the price at the pumps by 4½p and 3½p a gallon respectively. This does no more than keep pace with inflation. The changes will take effect for oil delivered from refineries, and warehouses from six o'clock this evening. I do not propose to increase the duty on heavy fuel oil, which is of particular importance to industrial costs.

There is one excise duty which I propose to do away with althogether. Many of those who find it hardest to make ends meet, including in particular many pensioners, use paraffin stoves to heat their homes. It is with them in mind that I propose to abolish the duty on kerosene from six o'clock tonight. I am sure that this will be welcomed on all sides of the House.

The various rates of vehicle excise duty will, once again, go up roughly in line with prices. Thus the duty for cars and light vans will be increased by £5, from £85 to £90 a year. However, in the light of the reassessment by my Rt Hon Friend the Secretary of State for Transport of the wear and tear that various types of vehicle cause to the road, there will be reductions in duty for the lightest lorries, offset by higher increases for some heavier lorries. All these changes in vehicle excise duty will take effect from tomorrow.

However, I propose to exempt from vehicle excise duty all recipients of the war pensioners' mobility supplement. In addition, the existing VAT relief for motor vehicles designed or adapted for use by the handicapped will be extended, and matched by a new car tax relief. The effect will be that neither VAT nor car tax will apply to family cars designed for disabled people or substantially adapted for their use.

E.C. rules on alcoholic drinks duty

I now come to the most difficult decision I have to take in the excise duty field. As the House will be aware, the rules of the European Community, so far as alcoholic drinks are concerned, are designed to prevent a member state from protecting its own domestic product by imposing a significantly higher duty on competing imports. In pursuit of this, the Commission has taken a number of countries to the European Court of Justice.

In our case, the Commission contended that we were protecting beer by under-taxing it in relation to wine. We fought the case, but lost; and I am now implementing the judgment handed down by the court last year. Accordingly, I propose to increase the duty on beer by the minimum amount needed to comply with the judgment and maintain revenue; 2p on a typical pint of beer , including VAT. At the same time wine will be reduced by the equivalent of about 18p a bottle, again including VAT.

We have thus complied with the court's judgment. And I am happy to be able to tell the House that the Italian Government have, after discussions, given us an undertaking that they will comply with earlier court rulings on discrimination against Scotch whisky.

As for the rest of the alcoholic drinks, cider, which increasingly compete with beer but attracts a lower duty, will go up by 3p a pint. The duties on made-wine will be aligned with those on other wine. And I propose to increase the duty on sparkling wine, fortified wine and spirits by about 10p a bottle, including VAT. All these changes will take effect from midnight tonight.

These changes in excise duties will, all told, bring in some £840m in 1984-85, some £200m more than is required to keep pace with inflation. The addition is of course due to the increase in tobacco duty.

The remainder of the extra revenue I need to enable me to make a substantial switch this year from taxes on earnings to taxes on spending must come from VAT. I propose no change in the rate of VAT. Instead, I intend to broaden the base of the tax by extending the 15 per cent rate to two areas of expenditure that have hitherto been zero-rated.

First, alterations to buildings. At present repairs and maintenance are taxed, but alterations are not. The borderline between these two categories is the most confused in the whole field of VAT. I propose to end this confusion and illogicality by bringing all alterations into tax.

I recognise that this will be unwelcome news for the construction industry, but construction will of course benefit greatly from the reduction in the rate of stamp duty which I have already announced.

£290m of the cost of that reduction in 1984-85 relates to transfers of land on buildings, and of that £290m some 90 per cent relates to buildings and building land. Nevertheless, to allow a reasonable time for existing commitments to be completed or adjusted, the VAT change will be deferred until June 1.

Secondly, food. Most food is zero-rated. But food served in restaurants is taxed, together with a miscellaneous range of items including ice-cream, confectionery, soft drinks and crisps, which where brought into tax by the Rt Hon Member for Leeds East. Takeaway food clearly competes with other forms of catering, and I therefore intend to bring into tax hot take-away food and drinks, with effect from May 1.

The total effect of the extensions of the VAT coverage which I have proposed will be to increase the yield of the tax by £375m in 1984-85 and by £650m in a full year.

The total impact effect on the retail price index of the VAT changes and excise duty changes taken together will be less than three-quarters of 1 per cent. This has already been taken into account in the forecast which I have given to the House of a decline in inflation to 4½ per cent by the end of the year.

The extra revenue raised in this way will enable me, within the overall framework of a neutral Budget, to lighten the burden of income tax.

No change in individual income tax rates

Since we took office in 1979, we have cut the basic rate of income tax from 33 per cent to 30 per cent and sharply reduced the confiscatory higher rates inherited from the last Labour Government. We have increased the main tax allowances not simply in line with prices but by around 8 per cent in real terms. It is a good record. But it is not enough. The burden of income tax is still too heavy.

The burden of income tax is still too heavy.

During the lifetime of this Parliament, I intend to carry forward the progress we have already made. For the most part, this will have to wait for future budgets, particularly since I have thought it right this year to concentrate on setting a new regime of business taxation for the lifetime of a Parliament – and beyond. But as a result of the changes to taxes on spending which I have just announced, I can take a further step in this Budget.

I propose to make no change this year in the rates of income tax. So far as the allowances and thresholds are concerned, I must clearly increase these by amounts set out in the statutory indexation formula, based on the 5.3 per cent increase in the retail price index to December. The question is how much more I can do, and how to direct it.

I have decided that, this year, the right course is to use every penny I have in hand, within the framework of a revenue neutral Budget, to lift the level of the basic tax thresholds, for the married and single alike. It makes very little sense to be collecting income tax from people who are at the same time receiving means-tested benefits. Moreover low tax thresholds worsen the poverty and unemployment traps, so that there is little if any financial incentive to find a better job or even any job at all.

There is, alas, no quick or cheap solution to these problems. But that is all the more reason to make a further move towards solving them now.

I propose to increase the other thresholds in line with the statutory indexation requirement, but by no more. The first higher rate of 40 per cent will apply when taxable income reaches £15,400 a year and the top rate of 60 per cent to taxable income over £38,000. The single age allowance will rise from £2,360 to £2,490 and the married age allowance from £3,755 to £3,955.

For the basic thresholds, statutory indexation would mean putting the single and married allowances up by £100 and £150 respectively. I am glad to say that I can do considerably better than that. I propose to increase the basic thresholds by well over double what is required by indexation. The single person's allowance will be increased by £220, from £1,785 to £2,005; and the married man's allowance by £360, from £2,795 to £3,155.

This is an increase of around 12½ per cent or some 7 per cent in real terms. It brings the married man's tax allowance for 1984-85 to its highest level in real terms since the war. It means that the great majority of married couples will enjoy an income tax cut of at least £2 a week. And it means that a large number of people, those with the smallest incomes of all, are taken out of income tax altogether. Some 850,000 people – over 100,000 of them widows – who would have paid tax if thresholds had not been increased will pay no tax in 1984-85. That is 400,000 more taken out of tax than if the allowances had merely been indexed.

All these changes will take effect under PAYE on the first day after May 10. Their cost is considerable: some £1.8bn in 1984-85, of which roughly half represents the cost of indexation.

This is as far as I can go on income tax this year, within a broadly revenue-neutral Budget for 1984-85. But so long as we hold to our published planned levels of public spending, there is an excellent prospect of further cuts in income tax in next year's Budget. These would be on top of the measures I have announced in this Budget which, as I have already told the house, will reduce taxation in 1985-86 by well over £1¾bn, with business taking the lion's share.

I have, Mr Deputy Speaker, completed the course I charted at the outset this afternoon. I have described the recovery, and how the Government plans to sustain it, and assist the creation of new jobs. I have reaffirmed our commitment to further reductions in inflation, by maintaining sound money and by curbing government borrowing. I have embarked on a radical programme of tax reform, abolishing outright two major taxes – the investment income surcharge and the National Insurance surcharge. And I have been able to propose measures which will significantly reduce the burden of taxation over the next two years. I commend this Budget to the House.

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Contributions by various authors include: Anatomy of the U.S. individual income tax, by Joseph A. Pechman; Net wealth, gift, and transfer taxes, by Alan A. Tait; The retail sales tax: The United States experience, by John F. Due; Taxation and income distribution, by Luc de Wulf; Some topical issues concerning international double taxation, by Leif Mutén.
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Consolidated to April 15, 1983. 53rd edition.
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Toronto, Butterworths, 1982.
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Supplements to bring the book up to date appear regularly.
(We have already received the 11th supplement since the book's introduction in 1982.)
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Belgium

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United Kingdom

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Butterworth & Co., London.

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MAY 1984

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Fondation pour l'Etude du Droit et des Usages du Commerce International (FEDUCI): Fiscalité des opérations internationales (Seminar) (Taxation of international operations). Paris (France), 21, 22 and 23 May (French).

JUNE 1984

Taxation Institute of Australia: 3rd International Congress (including Hong Kong as gateway to the East–Hong Kong tax problems and advantages; outline of Japanese tax system and taxation of corporations; an analysis of Japanese–Australian double tax agreements; division 13 and other Australian tax considerations affecting Japanese/Australian investments; Japanese taxation of executives/Japanese executives taxed in Australia/Australian executives taxed in Japan). Hong Kong, 3 June; Tokyo (Japan), 5-9 June (English).

The Hartford Institute on Insurance Taxation: 1984 International conference on insurance taxation (including: survey of taxation rules of life insurance companies; life policyholder taxation – an international comparison; tax havens and captives; foreign insurers operating in the United Kingdom). London (United Kingdom), 24-26 June (English).

SEPTEMBER 1984

International Bar Association: Twentieth Biennial Conference (including: measures against treaty shopping; important new developments in national tax legislation as well as current activities of international organisations in the tax field; residence and transfer of residence of bodies corporate). Vienna (Austria), September 2-7 (English).

International Tax Planning Association: Monte Carlo Workshop. Monte Carlo (France), 13 and 14 September (English).

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina). 16-21 September (English, French, German, Spanish).

OCTOBER 1984

University of Miami: 39th Annual University of Miami Tax Conference. Miami (U.S.A.), 15-19 October (English).

NOVEMBER 1984

International Tax Planning Association: Hong Kong Seminar. Hong Kong, 26 and 27 November (English).

FOR FURTHER INFORMATION PLEASE WRITE TO:

International Bar Association: 2 Harewood Place, Hanover Square, London W1R 9HB (United Kingdom).

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

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

FEDUCI, 15 Boulevard Exelmans, F 75016 Paris (France).

The Hartford Institute on Insurance Taxation: Post Office Box 845, Avon, Connecticut 06001 U.S.A.

Middle East Economic Digest Conferences: MEED House, 21 John Street, London WC1N2BP (United Kingdom).

Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41 (Federal Republic of Germany).

Taxation Institute of Australia, 19th Floor, Caga Centre, 8-18 Bent Street, Sydney 2000, Australia.

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UNITED KINGDOM:

Tax Legislation: Consultation, Enactment and Revenue Practice

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The following is the text of the first paper delivered at the joint seminar of the U.K. and U.S. branches of IFA in London in October 1983. The second paper on this topic, by Peter G. Whiteman, QC, was published in the Bulletin for international fiscal documentation 12 (1983) at 531. The following paper has been updated to take account of the United Kingdom's 1984 Budget, delivered by the Chancellor of the Exchequer, the Rt. Hon. Nigel Lawson, on 13 March 1984 and the House of Lords' judgment in *Furniss* v. *Dawson*. An article by the present author on this judgment was published in 38 Bulletin for international fiscal documentation, 4 (1984) at 147.

The author acknowledges his indebtedness to Erskine May's *Parliamentary Practice*, 20th edition, 1983 (Butterworths) in preparing this article.

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INTRODUCTION

The process of consultation on prospective tax legislation in the U.K. has to be viewed in the light of the overall budgetary process. The Budget, which is presented usually in March or April, is the focal point of the tax year. While it offers the Chancellor of the Exchequer the opportunity to review past economic performance and set out his future economic strategy, it is essentially concerned with taxation rather than expenditure and taxation. This article accordingly deals with the revenue raising aspects of U.K. budgetary procedure rather than the expenditure or "supply" aspects.

The Budget is traditionally shrouded in secrecy. Speaking in February 1977, Sir Geoffrey Howe, who was later to hold the office of Chancellor of the Exchequer throughout the current Conservative Government's first term of office between 1979 and 1983, could say that it was presented as "a fiscal fait accompli, receptive to neither the benefit nor the opportunity of prior examination or constructive comments".[1] Despite pressure for reform of the budgetary process,[2] in its essential budgetary aspects this continues to be the case.[3] On the more technical aspects of the Budget, however, substantial progress has been made in recent years in the consultative process which has led eventually to legislation in the annual Finance Bill. Inevitably, however, the consultative process has tended to be more concerned with the *means* by which a particular end is achieved rather than the *policy* that underlies the decision that those ends should be achieved in one way or another. Thus, in his Budget on 13 March 1984, the present Chancellor, Nigel Lawson, was able to introduce without any prior debate or consultation a radical reversal of policy in business taxation by stripping businesses, over a two-year period, of the substantial investment incentives enjoyed through the capital allowances system, a system which was enhanced in several respects by his predecessor, Sir Geoffrey Howe. While that change will be debated after the event, failure to carry the proposal in Parliament is unlikely and would probably lead to the Chancellor's resignation.

Consultation and representations for change in the tax system lead up to the Budget. Thereafter the Budget proposals are enacted in the Finance Bill and this provides opportunity for further representations within the fairly tight legislative timetable (see below). The following sections of this article describe the various processes in greater detail.

1. "Reform of Taxation Machinery", text of an address given to the Addington Society on February 16, 1977; reproduced at [1977] *British Tax Review*, 97.
2. See "Budgetary Reform in the UK", Institute for Fiscal Studies, 1980; "Budgetary Reform", 6th Report of the Treasury and Civil Service Committee, May 1982.
3. Following the Budget on 13 March 1984 it was announced that the police were to investigate the publication on 1 March 1984 by the *Guardian* newspaper of uncannily accurate details of several of the Budget proposals.

CONSULTATION

Consultation on prospective tax legislation or tax reform is undertaken in a number of different ways. There are four broad approaches:

(a) scrutiny through "independent" Government appointed bodies, for example, Royal Commissions or other official committees appointed specifically to enquire into the tax system, which will examine aspects of the tax system within their terms of reference;
(b) "Government inspired" consultation, for example, through the issue of green papers (see below) and Inland Revenue consultative papers calling upon interested persons to comment on the proposals put forward in them;
(c) Parliamentary scrutiny of the tax system as, for example, in debates on tax matters, especially the Finance Bill debates, and through the Treasury and Civil Service Committee; and
(d) pressure from outside representative and research bodies.

The greater part of the consultative effort by those consulted tends to be "reactive": consultation takes place on the Government's instigation when it appoints an "independent" body or issues a consultative document or green paper. The major exception to this is the Budget representations which interested bodies make to the Revenue departments, the Treasury and the Government Ministers concerned, suggesting those matters which they consider should be included in the forthcoming Budget. Once the Budget has been delivered, however, the Finance Bill stage of the legislative process is essentially reactive to what is contained in the Bill, it for the most part being accepted that the Chancellor is less likely to agree to completely new measures for insertion in the current year's Finance Bill.

Until the mid to late 1970s, most Government-inspired consultation was through independent bodies within (a) above. Examples of such bodies were the Royal Commissions of 1920 and 1955.[4] A more recent example can be found in the Committee on Enforcement powers of the Revenue departments, under the Chairmanship of Lord Keith, whose reports[5] may in due course lead to a fundamental restructuring of the administration of taxes in the U.K. For important changes in the structure of tax legislation, the Government of the day has also used official issued Government Papers ("green" and "white" papers), which are approved for publication by the Crown and laid before Parliament – "Presented to Parliament by Command of Her Majesty" – to put forward proposals for consultation. Examples of these include papers on the Reform of Corporation Tax,[6] Value Added Tax,[7] Proposals for a Tax Credit System,[8] Inheritance Tax,[9] and Wealth Tax[10] and, of these proposals, all except that on VAT and Inheritance Tax were accompanied by the appointment of a Parliamentary Select Committee to take evidence on the proposals, to consider them and to report upon them.[11] In a number of cases, a white paper containing more specific proposals was published,[12] followed by legislative action.[13] In recent years, however, the green paper procedure, when followed, has been less formal and, in both cases, Corporation Tax[14] and the Taxation of Husband and Wife,[15] has yet to be followed by legislative action.[16] The Treasury and Civil Service Committee of the House of Commons, established in 1979, has, however, provided the medium for examining a number of policy aspects of the tax system.[17]

In the last five years, however, the emphasis in consultation has moved towards papers issued by the Inland Revenue. Early examples of these are found in 1976 in the paper on exchange profits and losses[18] and in 1977 with that on the indexation of capital gains tax.[19] Since 1979 the number of papers issued has increased rapidly.[20] Generally there are four broad types of consultative paper:

(i) Those dealing with topics of current interest but with no legislative promise, which outline various options in more or less detail and from a more or less positive/negative standpoint. Examples of these were the papers on exchange profits and losses[21] in 1976 and on stamp duty in March 1983.[22]
(ii) Those dealing with topics on which legislative action is promised or almost certain but on which comments on the broad approach are required. An example of this is the paper on companies purchasing their own shares issued in September 1981.[23]

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4. See "Twenty-five years on from the Royal Commission", Arthur Johnstone, [1980] *British Tax Review*, 294.
5. Volumes 1 & 2, Cmnd 8822, March 1983 and Volume 3, Cmnd 9120, Jan. 1984. Volume 4 is yet to be published.
6. "Reform of Corporation Tax", Cmnd 4630, March 1971.
7. "Value Added Tax", Cmnd 4621, March 1971.
8. "Proposals for a Tax Credit System", Cmnd 5116, October 1972.
9. "Taxation of Capital on Death: A possible Inheritance Tax in place of Estate Duty", Cmnd 4930, March 1972.
10. "Wealth Tax", Cmnd 5704, August 1974.
11. For the use of Green Paper procedure see "Open Government: The use of Green Papers", Cedric Sandford, [1980] *British Tax Review*, 294.
12. For example, "Value Added Tax", Cmnd 4929, March 1972 and "Reform of Corporation Tax", Cmnd 4955, April 1972.
13. In the case of both VAT and Corporation Tax the proposals were contained in the Finance Act 1972.
14. "Corporation Tax", Cmnd 8456, January 1982.
15. "The Taxation of Husband and Wife", Cmnd 8093, December 1980.
16. While the changes in business taxation introduced in the 1984 Budget were along the lines of one of the alternatives discussed in the Corporation Tax Green Paper of January 1982, the Chancellor did not seek in any way to justify his approach by reference to the results of the consultation that took place on the Green Paper. Indeed, the author is not aware of any body which responded to the Green Paper which advocated the approach adopted by the Chancellor. The Chancellor did, however, justify his decision to retain an imputation system by reference to the responses to the Green Paper.
17. For example, "The Structure of Personal Income Taxation and Income Support", Third Special Report from the Treasury and Civil Service Committee, Session 1982/83, HC 386, 11 May 1983.
18. "Borrowings in Foreign Currency", October 1976.
19. "Capital Gains Tax: Tapering Relief", October 1977.
20. Since the Conservative Government came into office in 1979, approximately 40 consultative papers or items of draft legislation have been published.
21. "Borrowings in Foreign Currency", October 1976. No legislation or further proposals based on this paper has ever been brought forward.
22. "The Reform of Stamp Duties", March 1983. Ad valorem stamp duty was reduced from 2% to 1% in the 1984 Budget and certain other changes were made. Major reform is still awaited.
23. "Companies purchasing their own shares: Implications for corporation tax and capital gains tax", September 1981, which was followed by legislation in the Finance Act 1982.

(iii) Those dealing with topics on which legislative action is promised and on which comments are required on the technical detail of implementation. An example is the paper on stock relief issued in November 1980.[24]

(iv) Those containing draft legislation, published in advance of the Finance Bill, as for example in the case of the proposals on controlled foreign companies[25] and on furnished lettings.[26]

Generally, consultative papers are issued to the world at large and any interested party may respond within the time limit set for comments.[27] Representative and professional bodies, such as the Confederation of British Industry and the Association of British Chambers of Commerce, the Institute of Taxation, the Law Society and the accountancy bodies, invariably do so. In some cases, some consultation may take place on a limited and initially unpublished basis with those bodies particularly concerned with the proposals in question.[28] Generally speaking, there will be less consultation on proposals for new tax avoidance legislation and, should consultation take place, it is likely to be on the basis that the Government has announced its intention to act and the detailed legislative measures, on which consultation takes place, will be backdated to the time at which the announcement of such action was made.[29]

ENACTMENT OF LEGISLATION

The grant of taxation

The basic constitutional relationship of the Crown, the Lords and the House of Commons in relation to the levying of taxation in the U.K. is that:

(a) the Crown makes known to the Commons its financial requirements,

(b) the House of Commons grants to the Crown the means of meeting those requirements, and

(c) the Lords assent to the grant made by the Commons.

The demands of the Crown are, nowadays, devised and made through Ministers who are also duly elected members of Parliament. The chief among those Ministers on financial matters, the Chancellor of the Exchequer, will be the person who proposes in his Budget the means by which those demands are to be met. Nevertheless, the constitutional relationship is still of fundamental significance to the financial procedure of Parliament. For example, the House of Commons is not itself free to impose or augment tax but may only do so if it is required to meet expenditure demanded by the Crown through Government Ministers.

This article is concerned primarily with the grant through taxation ("ways and means") of the means to meet expenditure duly demanded ("supply"). The authorisation of expenditure and taxation is covered by the financial procedure of the Commons and the financial procedure is concerned with two forms of "charges":

(i) a charge upon the public revenue, that is an item of national expenditure, and

(ii) a charge upon the people, that is a tax or customs duty.

There are four general rules relating to the financial procedure in the House of Commons and, in basic terms, they are as follows:

(1) a charge must normally originate in the House of Commons and must be authorised by legislation;

(2) to be considered, a charge must be demanded by or recommended from the Crown;[30]

(3) the first consideration of a charge must be in the form of a resolution[31] which, once agreed to, constitutes the basis of the Bill which will eventually authorise the charge; and

(4) not more than one stage of the Bill founded upon a charging resolution can be taken on one day.[32]

In the application of these rules to ways and means, the principal source of legislative authority under (a) above is to be found in the annual Finance Bill. The Royal demand or recommendation under (b) above is not signified directly in relation to ways and means because it is regarded as implied in the demand that the Crown makes for supply. Originally, the royal initiative was thought only to extend to the *amount* of the tax to be raised, so that the Commons could reject the tax proposed and bring in alternative measures to raise the revenue demanded. This later developed, however, into the position that the Royal initiative in taxation matters extended to both the *amount* and the *incidence* of tax. Thus, an amendment to a resolution designed to switch the burden of taxation between taxpayers is an infringement of this initiative. It was this later development in the nineteenth century that led to the Royal initiative in ways and means being indicated by the introduction of resolutions by a Minister of the Crown. The resolution sets the standard by which the admissibility of amendments is judged.

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24. "Stock relief – a consultative paper", 14 November 1980, which was followed by legislation in the Finance Act 1981.
25. Most recently contained in "Draft Clauses and Schedules relating to Controlled Foreign Companies", October 1983. The provisions will be included in the 1984 Finance Bill.
26. "Furnished holiday lettings", 31 January 1984. The provisions will be included in the 1984 Finance Bill.
27. A common complaint is that, given the need of most representative and professional bodies to convene committees to consider the proposals and finalise comments, insufficient time is allowed for proper consideration of the proposals. For example, draft clauses on offshore and overseas funds, amounting to 25 pages of legislation, were published on 22 February 1984 and comments were to be sent to the Inland Revenue by 12 March 1984.
28. In relation to the Treasury memorandum on the National Heritage, see HC Written Answers, 6 August 1980, Vol. 990, cols 159-160. More recently on Gaming Machines (Licence Duty), see HC Official Report, 15 February 1984, Vol 54, col 206. At a conference organised by the Institute for Fiscal Studies on 2 March 1984, one of the Deputy Chairmen of the Inland Revenue also indicated in response to questions that informal discussions had taken place recently on the treatment of capital losses within groups of companies.
29. For example, the proposals on group relief announced on 8 November 1983 take effect from that date, even though modified in the light of representations. The proposals on offshore and overseas funds, to be included in the Finance Bill 1984, only take effect, however, from 1 January 1984 despite an announcement on 15 September 1983 that legislation would be introduced.
30. House of Commons, Standing Order No. 109.
31. SO No. 110.
32. In practice this rule is not always adhered to, as for example in the case of the 1983 Finance Act when the committee stage was immediately followed by the third reading to ensure the passage of the Bill prior to the dissolution of Parliament and the General Election. The same had happened in similar circumstances in 1979.

Ways and means resolutions

A charge upon the people, which must accordingly be initiated by a ways and means resolution, encompasses the following:

(a) the imposition of a new tax;
(b) the continuation of an expiring tax;
(c) the reimposition of a repealed or expired tax;
(d) the increase in the rate of an existing tax;
(e) the extension of the incidence of tax;
(f) the repeal of an exemption from tax; and
(g) the delegation of a taxing power to an authority other than the House of Commons.

Generally tax revenues are paid into the Consolidated Fund[33] and payments out of that fund to meet expenditure demanded, or "supply", must be similarly authorised by resolution and legislation under the rules of financial procedure.[34] Where the action in question does not involve payments into or out of that Fund, the rules of financial procedure need not be complied with. Thus, a ways and means resolution is not required for matters such as the following:

(a) proposals for raising receipts for local authorities, unless the receipt is in fact a grant out of the Consolidated Fund;
(b) measures to alleviate taxation as, for example, the repeal or reduction of a tax charge or the extension of exemptions, provided that the incidental effect of the measure is not to increase the tax burden on others, however indirect or insignificant;
(c) levies upon an industry for its own purposes;
(d) payments, for example, in the form of fees or licences, to cover expenses of a Government department in providing services; and
(e) the imposition of a tax authorised by an existing law or of tax which is imposed conditionally upon subsequent legislation, although in this latter case the later legislation bringing it into effect must be subject to a ways and means resolution.

Budget resolutions

A ways and means motion may be made in the House without notice on any day as soon as an address has been agreed to in answer to Her Majesty's Speech which opens the Parliamentary Session.[35] The general rule is that each ways and means resolution must be considered separately. The most important ways and means resolutions are, however, those introduced by the Chancellor of the Exchequer in his annual Budget statement. The debate that follows the introduction of these resolutions must consider the whole of the Government's economic strategy, the expenditure it is to incur and the consequential need to raise revenue, a need which is reflected not only in the resolutions proposed but also in the existing system of taxation, a number of aspects of which may be quite unaffected by the proposed resolutions. For that reason, the Budget debate proceeds on the basis of one only of the Budget resolutions and this is generally upon the resolution for the amendment of law, which may be in the following terms:

> that it is expedient to amend the law with respect to the national debt and the public revenue and to make further provisions in connection with finance...

The Budget debate which is normally spread over four days is concluded by a vote on this general resolution. Immediately following the passing of that resolution, the remaining Budget resolutions are put and voted upon without debate.[36]

The Provisional Collection of Taxes Act 1968

As has been mentioned, a charge upon the people must originate in the House of Commons and is not fully valid until authorised by legislation. A major exception to this principle is, however, contained in the Provisional Collection of Taxes Act 1968 (PCTA 1968). This enables certain annual taxes which would otherwise expire to continue to have effect *as if* authorised by legislation, pending the passage of the Finance Bill. The most important of these taxes is income tax but the PCTA 1968 also extends to corporation tax, petroleum revenue tax, value added tax, car tax and customs & excise duties. Under section 5 of the PCTA 1968, authority is given for the House of Commons to give provisional statutory effect to certain of the Budget resolutions which will be passed at the conclusion of the Budget debate. The specified Budget resolutions are proposed by means of a single motion which may be put without notice under Standing Order 114(2). The Chancellor of the Exchequer normally moves this motion at the end of his Budget Speech, before the general amendment of the law resolution is put to open the Budget debate (see above). Immediate effect is, accordingly, given to proposals such as the increase in excise duties on tobacco, petrol, beer, wine and spirits.[37]

Under section 1 of the PCTA 1968 Act it is provided that, if the House of Commons passes a resolution providing for:

(i) the renewal for a further period of any existing tax then in force or imposed during the previous financial year, or
(ii) for the variation or abolition of any existing tax,

the resolution has statutory effect as if contained in an Act of Parliament. The resolution must, however, contain a declaration that it is expedient in the public interest that the resolution should have that effect. The imposition and collection of tax is, accordingly, safeguarded while the Finance Bill is passing through Parliament. The PCTA 1968 cannot, however, apply to any new tax or duty, and assessment and collection of such taxes or duties must await the passage of the Finance Bill even though, once that is passed, the imposition takes effect from an earlier date, as for example the beginning of the tax year on 6 April.

33. Exchequer and Audit Departments Act 1866, s10.
34. The specific rules regarding public money are now contained in Standing Orders of the House of Commons, Nos. 109-115.
35. SO No. 114(1).
36. SO No. 114(3).
37. Changes to certain excise duties announced in the Budget normally take effect from 18.00 hours (Hydrocarbon oils) or midnight (alcoholic drink) on Budget day in respect of supplies removed from bond or warehouse after that time.

A resolution given effect to under the PCTA 1968 will cease to have statutory effect unless, within 25 sitting days after that on which the resolution is passed, the Finance Bill receives its second reading or a Bill is amended so as to include provision for the renewal, variation or abolition of the tax covered by the resolution i.e. within that time there must be a legislative measure before Parliament which, if passed, will give actual legislative effect to the proposal. Consistent with this principle, a resolution also ceases to have statutory effect if the provisions giving effect to it are rejected during the passage through the House of the Bill containing them or Parliament is dissolved or prorogued.[38]

Obviously, once the Act giving effect to the resolution comes into force, the resolution is superseded and ceases to apply. However, this must occur within a specified time as the resolution only has effect for a limited period. Where the resolution is passed in March or April in any year its effect only lasts until 5 August in the same calendar year. If it is passed at any other time, it expires at the end of four months after the date on which it is expressed to take effect or, if no such date is expressed, after the date on which it is passed.[39] It is this limited effect of a resolution that provides the impetus to pass the Finance Bill within a strict timetable so as to give real statutory effect to the Government's proposals as opposed to the temporary authorisation under the PCTA 1968.

THE FINANCE BILL

The introduction of the Bill

A Bill may be introduced to Parliament in three ways:

(a) it may be brought in upon an order of the House;
(b) it may be presented, without an order, under Standing Order No. 39(1), or
(c) it may be brought down from the Lords.

The normal procedure is to bring in a Bill on notice under Standing Order No. 39(1). The order procedure under (a) above is, however, retained (and is essentially confined to) Bills founded upon supply, ways and means and other financial resolutions. Bills presented under an order are divided into two classes:

(i) Bills preceded by preliminary proceedings, and
(ii) Bills ordered in without such proceedings.

Bills involving charges on the people cannot be brought in under (ii) and, as will be apparent from the above, Finance Bills are introduced by way of preliminary proceedings based upon the Budget resolutions. Once the Budget resolutions have been presented and passed at the end of the Budget debate, the Bill is ordered to be introduced.[40] It must then be presented by one of the members ordered to bring it in. The member appointed obtains a "dummy" Bill and goes to the bar of the House and, on being called by the Speaker, proceeds to the table (with the customary three bows), hands the dummy Bill to the Clerk of the House, who reads the short title aloud. This completes the first reading of the Bill and no questions may be put on it at that reading. At the same time it is ordered to be read a second time on such day as the member presenting it appoints and it is ordered to be printed.[41] A common form of layout is adopted in a Bill: a short title appears at the head of the front page and a list of clauses (which upon enactment will be referred to as "sections") and Schedules is set out at the beginning. Before the actual clauses and Schedules comes the long title of the Bill, a preamble and enacting formula. In the Finance Bill, after the list of clauses and Schedules, the following appears:

A
BILL
TO

> Grant certain duties, to alter other duties, and to amend the law relating to the National Debt and the Public Revenue, and to make further provision in connection with Finance.
>
> Most Gracious Sovereign,
>
> We, Your Majesty's most dutiful and loyal subjects, the Commons of the United Kingdom in Parliament assembled, towards raising the necessary supplies to defray Your Majesty's public expenses, and making an addition to the public revenue, have freely and voluntarily resolved to give and grant unto Your Majesty the several duties hereinafter mentioned; and do therefore most humbly beseech Your Majesty that it may be enacted, and be it enacted by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:-

It should be noted that the short title of the Bill, which appears at the top of the front page, may differ from its final title as an Act (and accordingly the title contained in the citation clause at the end of the Bill). Thus, the Finance Bill 1983, which was the first Bill of the new Parliamentary session following the General Election in 1983, became the Finance (No. 2) Act 1983 because it was the second Finance Act to be passed in 1983 (the first Finance Act being completed in the previous Parliament before the General Election). On the other hand, the 1984 Bill will be known as the Finance (No. 2) Bill 1984 as it is the second Finance Bill of the current Parliamentary session, but it will become the Finance Act 1984 as it is the first Finance Act of that year. The Bill is examined by the clerks in the Public Bill office who ensure that its contents are authorised by the resolutions and that the proper procedure has been followed.

The Commons stages of the Bill

A Bill passes through a variety of stages in the House of Commons and each stage of the Bill enables it to be considered in full. Thus the fact that a point was raised and debated at an earlier stage does not preclude subsequent debate on the same points. The various stages and their purposes are as follows:

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38. PCTA 1968, s1(4), (5).
39. PCTA 1968, s1(3).
40. To indicate that the Bill embodies the free gift of taxation by the Commons to the Crown, the name of the Chairman of Ways and Means is listed first of those members of the House ordered to bring in the Bill, ahead of the name of any Minister so named. See also the enactment formula in the text.
41. SO No. 39(2).

(a) First reading – purely formal (see above).
(b) Second reading – the principles of the Bill are debated, including alternative ways of achieving the desired results.
(c) Committee – the details of the measures are considered and amendments proposed. Amendments must be consistent with the principle of the Bill established on second reading.
(d) Third reading – to review the Bill in its final forms. Only verbal amendments are accepted.

In the case of a Finance Bill, a second reading normally allows a general review of national finance to be debated. Until 1967, the Finance Bill and other Bills imposing taxes had to be committed to a Committee of the whole House of Commons for its committee stage. Since the Finance Bill 1968, however, the majority of the Finance Bills have been committed in part to a Standing Committee comprising a small number of MPs who represent the balance of the parties in the House of Commons. Certain clauses, primarily those of budgetary rather than technical significance (e.g. those setting the income tax rates of the year), are usually excluded from the Standing Committee's responsibility and, after it is reported from the Standing Committee, it is recommitted to a Committee of the whole House for completion of the committee stage. Amendments that are proposed to the Bill must not exceed its scope or seek to increase the amount or alter the incidence of any charge upon the people as authorised by the ways and means resolutions under which the provisions in the Bill are introduced. If new clauses or amendments are proposed which exceed the terms of those resolutions, further resolutions must be voted by the Commons coupled with instructions to the Standing Committee enabling it to consider such clauses or amendments. Amendments to reduce or omit a charge to tax are in order provided that they do not have the incidental effect of increasing a charge to tax on other persons.

Apart from these particular rules which are of relevance to Finance Bills, such a Bill is also governed by the usual rules of amendment for the committee stage of the legislative process. Thus, an amendment may be proposed to any clause or Schedule of the Bill, it can be proposed that clauses or Schedules be omitted and, subject to the limitations previously mentioned, new clauses and Schedules can be put forward for inclusion in the Bill. Amendments to the Bill must, however, be relevant to its subject matter and scope. Once a provision has been agreed to or amendments negatived, subsequent amendments cannot be proposed in committee if they are inconsistent with what has been agreed to or if they seek to bring up the matter that has been negatived.

Once the committee stage of the Bill is complete, the Bill as amended is reported to the House of Commons. Proceedings at the report stage are essentially a more formal repetition of the commitee stage and amendments previously rejected in committee may be put again. In the case of Finance Bills the most usual changes in the Bill at report stage are amendments or new clauses brought forward by the Government in response to points conceded by ministers in the committee stage debates. Thus, in committee a member may put forward an amendment which ministers accept in principle but contend that it is not properly drafted to achieve that principle. An appropriate amendment will then be introduced on report. Proceedings on report are governed by essentially the same rules for amendments as apply to the committee stage (see above).

On completion of the report stage the Bill is ordered to be read a third time. A Bill founded upon ways and means resolutions cannot usually go through more than one stage on the same day and, accordingly, a future day will be appointed for the third reading. However, this practice may be, and has been, waived by the Commons.[42]

The role of the House of Lords

Having passed its various stages in the Commons, the Bill proceeds to the House of Lords. However, the Lords' powers in relation to such legislation have long been restricted by the privileges of the House of Commons and, more recently, by the terms of the Parliament Act 1911. It is a breach of the Commons' privileges for the Lords to amend a Finance Bill. Only the Commons has the right to impose taxation and a proposal in the Lords to do so would be the clearest breach of privilege. However the privilege goes beyond this and *any* amendment to a Finance Bill is regarded as a breach of privilege. In the case of other Bills containing financial matters, a breach of privilege only occurs if the amendment involves some interference with a charge imposed under the Bill.

Although the right of amendment by the Lords was restricted in this way, the Lords retained their right to reject financial Bills without infringing the privileges of the House of Commons. Their right was, accordingly, either to assent to the measure or to reject it. Once it had become the practice to bring in all changes in taxation in a composite Finance Bill, it became impossible for the Lords to reject such a Bill without destroying the financial provision of the year. This very situation arose with the Finance Bill of 1909. The rejection of that Bill provided the motivation for the passing of the Parliament Act 1911 under which the Lords' right of rejection is curtailed. Under that Act, a Money Bill (which includes the Finance Bill) which has been passed by the House of Commons and sent to the House of Lords at least one month before the end of the Parliamentary session, but which is not passed by the House of Lords without amendment within one month after it has been so sent up, may (if the Commons so decides) be presented to the Queen and becomes an Act of Parliament on the Royal Assent being signified, notwithstanding the fact that the House of Lords has not assented to it.

The Royal Assent

Following passage of the Bill in the House of Lords, or its passage by default under the Parliament Act 1911, the Bill must receive the Royal Assent to become an Act. The Bill is returned to the custody of the Commons and,

42. See footnote 32 above.

when the House of Commons is summoned to the House of Lords to attend the Sovereign or the Lords Commissioners, the Bill is handed by the Speaker, at the Bar of the House of Lords, to the Clerk of the Parliaments to receive the Royal Assent. A Finance Bill, as a Bill for granting aids and supplies to the Crown, receives the Royal Assent before all other Bills. The Assent to such a Bill is declared in the special form of words: "La Reyne remercie ses bons sujets, accepte leur benevolence, et ainsi le veult."

INLAND REVENUE PRACTICE[43]

There is no formal system of Revenue practice in the United Kingdom, formal in the sense of directed by legislation, as opposed to established by Inland Revenue decision. When requested, the Inland Revenue will generally express its view of the interpretation or application of the tax system. There is, however, no general clearance or rulings procedure for transactions. The Inland Revenue's position has been stated in Parliament as follows:[44]

> In certain circumstances Inland Revenue Officers are, on the authority of the Board, prepared to comment on draft documents or on the taxation implications of some proposed financial or family arrangement, but such comment must necessarily be restricted to the narrow area where all the facts are known and all draft documents are available. In this connection the Board consider it important to make clear the nature of the primary duty of the Inland Revenue towards the taxpayer. It is to assess his liability after the end of the year in accordance with the statutory rules, so that the correct tax can be collected or repaid where appropriate. While tax offices try within reason to give informal general guidance about the tax system, or a particular part of it, to a taxpayer who seeks such help, it must be emphasised that they are not responsible for advising anyone on how to minimise his tax liability. In particular, they cannot become involved in advising about the correct drafting of legally binding documents, nor can they accept responsibility for assisting anyone to arrange his investment transactions during the course of the year so as to achieve the most favourable tax position by the end of it.

Despite the above, for certain specific statutory provisions a clearance procedure is created by the legislation[45] and in various other cases the Inland Revenue has indicated that it will consider and rule on the application of certain statutory provisions notwithstanding the absence of a statutory clearance procedure.[46] Whether, in the light of the uncertainty created by decisions such as that of the House of Lords in *Furniss* v *Dawson*,[47] this is a satisfactory position, is open to question.

Already, the suggestion has been made that formal rulings procedures will have to be introduced to enable taxpayers to ascertain whether or not the Inland Revenue will seek to apply the new approach.

The Inland Revenue's authority to adopt its practice in the administration of the tax system is contained in section 1 of the Taxes Management Act 1970 which provides that income tax, corporation tax and capital gains tax shall be under the care and management of the Commissioners of Inland Revenue. Similar provisions are made in respect of the other taxes and duties for which the Inland Revenue is responsible.[48] At present, Revenue practice becomes known in a multiplicity of ways:

(1) through direct dealings with the Inland Revenue by the taxpayer or his advisers in relation to the taxpayers' affairs;
(2) through general enquiries (that is not relating to a specific taxpayer's affairs) made of the Inland Revenue;
(3) through Inland Revenue contact and discussion with representative bodies such as the Institute of Taxation, Confederation of British Industry, Child Poverty Action Group and others;
(4) through publications of the Inland Revenue, in particular:
    (a) one of the series of explanatory leaflets;
    (b) guidance notes issued with assessments, tax returns or other tax forms;
    (c) Inland Revenue statements of practice;
    (d) Inland Revenue press releases;
    (e) Inland Revenue consultative documents;
    (f) through Parliamentary proceedings;
(5) through reports of tax cases;
(6) through speeches, lecturing and similar public contacts involving Inland Revenue staff; and
(7) through "leaks" of information through Inland Revenue staff who have left with accumulated knowledge.

The present ad hoc system of Inland Revenue practice, and the way in which it is communicated, has attracted criticism. Nevertheless, the Inland Revenue has taken substantial steps to place its practice and notification of its practice on a more formal basis in recent years. It is an area which, under the pressure of legislation and decisions such as that in *Dawson*, is likely to continue to develop considerably over the coming years.

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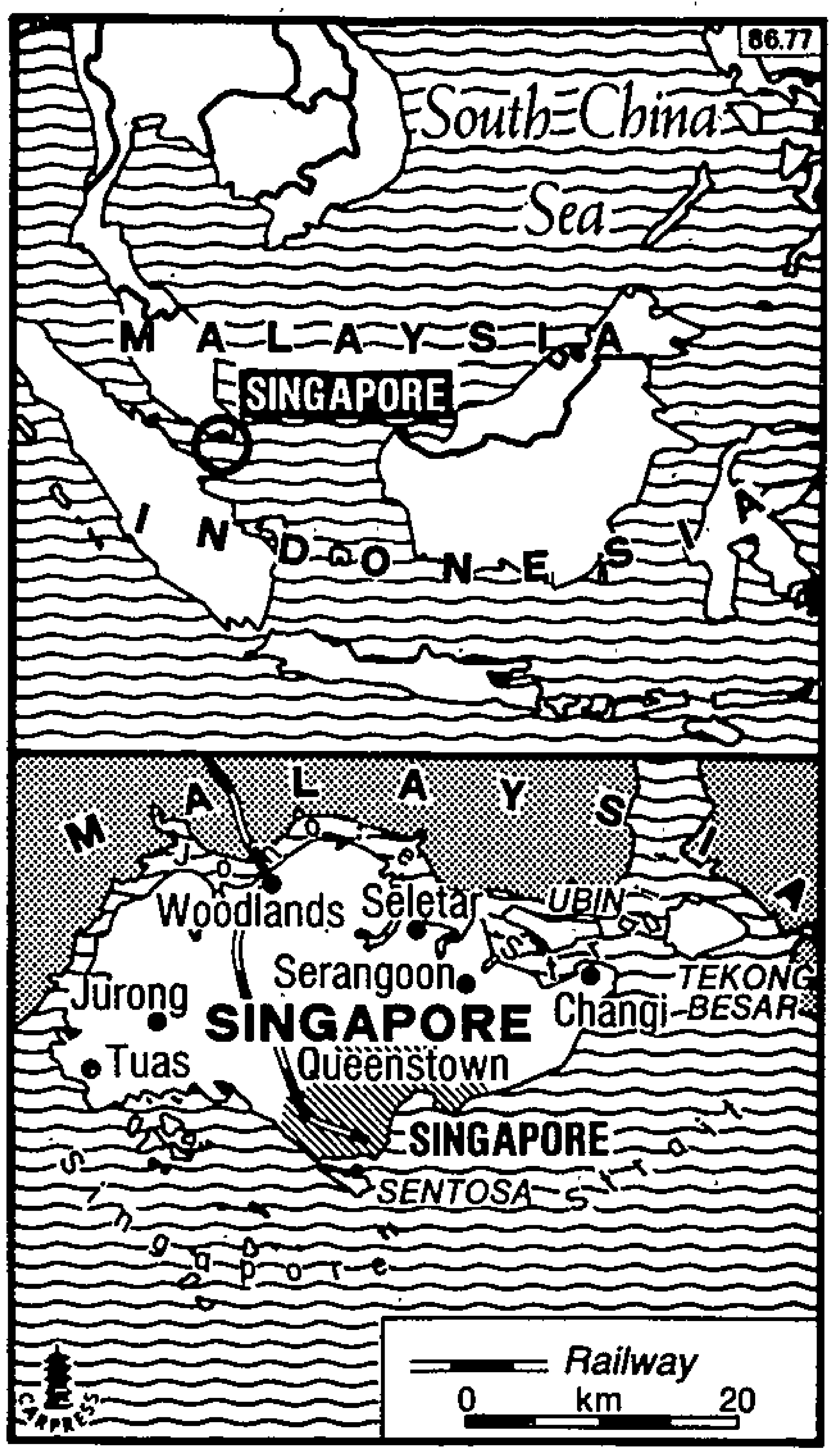
43. For a detailed examination of Revenue Practice, and proposals for reform, see "Revenue Practice: a suitable case for treatment", Malcolm Gammie, [1980] *British Tax Review*, 304.
44. Adjournment Debate, House of Commons Official Report, 25 July 1972, Col 1787.
45. See for example, ICTA 1970, s464 (transactions in securities); CGTA 1979, s88 (certain share exchanges, company reconstructions and amalgamations); FA 1980, Sched 18, para 17 (demergers); FA 1982, Sched 9, para 10 (companies buying their own shares); see also Bunker & Wyatt, *Inland Revenue Clearance* (Oyez Longman).
46. For example, under the Inland Revenue statement of practice on close companies, para 7, reproduced in *Inland Revenue Practices and Concessions* (Oyez Longman).
47. [1984] STC 153, see 38 *Bulletin for international fiscal documentation* 4 (1984) at 147. A report on the proceedings of a meeting of the Institute for Fiscal Studies to consider the implications of the decision will be published in the next issue of the Institute's journal, *Fiscal Studies*.
48. Stamp duty (s1, Stamp Duties Management Act 1891), capital transfer tax (FA 1975, Sched 4, para 1), development land tax (TMA 1970, s1 as applied by DLTA 1976, Sched 8) and petroleum revenue tax (OTA 1975, Sched 2, para 1).

A Summary of Singapore's 1984 Budget

By Lee Fook Hong, FCIS FAIA



Contents

Singapore's 1984 Budget was presented by the Minister for Finance, Dr. Tony Tan, to the Parliament of the Republic of Singapore on 2 March 1984. The Budget offers more tax incentives to companies and individuals, and introduces increases in duties on bets, cigarettes and liquors.

In accordance with tradition, the Minister presented his Budget Statement in three sections. In the first section he reviewed the progress of the Singapore economy in 1983 and the main points of Singapore's economic policy. In the second section he dealt with the expenditure and revenue estimates for the financial year 1984. Finally he announced the tax changes to meet the social and economic objectives of Singapore.

SECTION I

(1) The economy in 1983

In his review of the progress of the Singapore economy in 1983, the Minister happily remarked:

> We have done well in 1983. Our economy is in robust health. Investments expanded. Our currency is strong. Real incomes have risen. Inflation was minimal. This happy state of affairs is due in no small part to the past efforts of my predecessor as Minister for Finance, the late Mr. Hon Sui Sen. The economic policies, which he laid down, established a sound foundation which enabled our economy to weather the 1980-82 recession and emerge fitter for the experience. He has left us a solid base to build on.

As an open economy Singapore benefitted from the world economic recovery. Our economy expanded by a commendable 7.9% compared with 6.3% in 1982.

(2) Singapore's economic policy

After his review of Singapore's economy in 1983, the Minister elaborated on specific areas of Singapore's economic policy.

(a) Industrial development

On industrial development, the Minister was pleased to report that new investment commitments were $1.8 billion in 1983, slightly higher than in the previous year. Substantial investment was committed in the petroleum industry for process upgrading and energy conservation. A major portion of other commitments was for the manufacture of computer-related equipment and components, construction materials, food and chemicals.

The Minister appealed to local companies who wished to do well in a longer term to look for business opportunities in the newer technologies.

He, therefore, announced that local companies investing in approved venture capital projects in new technology industries would be able to write off up to 50% of the equity invested in such projects if the projects were to incur losses. Such companies should approach the Economic Development Board (EDB) for assistance in locating suitable foreign partners with a view to setting up joint venture projects in Singapore.

As more robots were being used in industry, the Minister said that in order to give a further impetus to robotization a robot leasing company had been established to provide consulting services as well as lease industrial robots and accessories. Companies wishing to automate or robotize should consult the EDB on the range of tax incentives available. Where there would be significant labor savings, the EDB would recommend to the Income Tax Department that the company be allowed to write off the cost of the robots in one year. Training facilities in the skills for the operation and maintenance of automated equipment were also being expanded and upgraded.

Referring to the Science Park, the Minister said the first phase was completed at the end of 1983. Companies involved in the development of industrial and educational robots and low-cost microcomputers and related peripherals would take up occupation in the Park in 1984.

(b) Prospects ahead

The Minister emphasized that to remain internationally competitive, Singapore's manufacturing industry would have no choice but to become technology and skill-intensive. He urged Singaporeans to examine new opportunities outside manufacturing. One area of activities which had come into prominence was that of internationally tradeable services which were mainly tourism, port services, air transportation, shipping and warehousing.

The Minister revealed that there were, however, new types of internationally tradeable services which could make use of Singapore's modern telecommunication and other infrastructural facilities. The EDB had started to promote investment in such services. So far it had concentrated on manufacturing related technical and engineering services. These included process control instrumentation, oil field services, aircraft maintenance and servicing, and engineering consultancy. The scope of services to be developed would be broadened to include all types of international services where Singapore had a comparative advantage.

(c) Trade development

On trade development the Minister expressed concern about the effects of protectionism. He lamented that although the world economy had started to recover, and trade had begun to grow again, protectionist sentiment had not abated. The Trade Development Board had commenced operations last year. Five advisory committees comprising representatives from a number of industries were formed to advise the Board on trading and marketing.

The Board had expanded its network of overseas offices. Two new ones were set up in Brussels and Dubai while honorary representatives were appointed in Sydney, Seoul and Dusseldorf. Efforts to explore opportunities in non-traditional markets were also intensified. The Board was drawing up a plan to increase its overseas representation over the next few years.

(d) ASEAN economic cooperation

The Minister said regional trade cooperation under the ASEAN Preferential Trading Arrangements (PTA) continued to strengthen. The ASEAN countries were making headway in the area of industrial cooperation. Under the ASEAN Industrial Project (AIP) Scheme, the Indonesian urea project recently came on stream while a similar Malaysian project was under construction. Details of the Thai and Filipino projects were being worked out. In Singapore, the production of Hepatitis B Vaccine had been identified as a suitable AIP. When formally accepted by the other countries, ASEAN would have its first set of 5 AIPs. To further increase cooperation, the ASEAN countries recently signed a Basic Agreement on Industrial Joint Venture which aimed to stimulate private investments in the region.

(e) Monetary and exchange rate policies

On monetary and exchange rate policies, the Minister said the Singapore exchange rate had to balance the twin objectives of minimizing imported inflation and safeguarding export competitiveness. Another major consideration was to ensure that international confidence in Singapore's economy was maintained. Faced with the uncertainties in the world economy and in the international financial system, the Monetary Authority sought to maintain a stable and strong Singapore dollar. The strength of the Singapore dollar was a reflection of the Government's prudent financial policy and the soundness of Singapore's economy.

(f) Financial services

In the last Budget Statement, the Minister had announced a tax exemption scheme for the promotion of loan syndication. The system had met with encouraging support. In view of the good response, the Minister had in the 1984 Budget decided to give further encouragement to similar types of activities and accordingly he announced that the tax exemption scheme would be extended to cover the syndication of guarantees, performance bonds and certain underwriting activities such as underwriting of floating rate notes and revolving underwriting facilities. To facilitate the growth of loan syndication activities, the Government had continued to be liberal in its admission of foreign law firms to service the legal documentation of loans.

Continuing, the Minister explained that another area for promotion was offshore fund management. In September 1983, a tax exemption scheme was introduced for non-resident investors who had their funds managed by approved ACUs in Singapore. The scheme exempts all income earned by non-residents from tax provided that their funds were managed by approved ACUs and the income was derived from offshore investment. Management fees of the fund managers would be taxed at the concessionary rate of 10%. Since the introduction 3 ACUs had been approved under the scheme and 5 more applications were being processed. The potential for growth in this area over the next few years would be good. A U.S. led world economic recovery should increase opportunities for investments, especially in the Asia-Pacific region where Singapore is well placed to play an intermediary role.

To further this objective, efforts would be made to seek more foreign shares and securities to be listed in Singapore. The latest was the listing in the Stock Exchange of Singapore of securities guaranteed by the U.S. Government National Mortgage Association under its Mortgage Backed Securities Scheme.

The Minister anticipated that financial futures would be making a formal entry into the Singapore financial scene this year. The link between the Singapore International Monetary Exchange and the International Monetary Markets of the Chicago Mercantile Exchange was the first of its kind, providing close to 24 hours trading in financial futures. Because it would be a new area of financial activity, various tax incentives would be given to help the futures market develop in the initial years. Since these would be foreign currency transactions, the tax incentives would be in line with those given to promote the offshore markets.

To further develop Singapore as an international futures market, the Minister said the number of futures contracts available for trading could be extended to other commodities. A possible area would be in oil futures.

(g) Tourism

The Minister repeated that the sector that had yet to recover from the world economic recession was tourism. In 1983, visitor arrivals fell by 4%. Earning from tourism, however, increased slightly by 3%. On the brighter side, the growth of Singapore's convention and exhibition business was sustained. The total of 927 "convention-type" events represented an increase of over 50% as compared to 1982.

In view of the overall poor performance last year, the Minister disclosed that Singapore Tourist Promotion Board would on its part co-operate closely with the tourist industry in promotional and other efforts both abroad and in Singapore. The Board would intensify its promotional activities in the U.S., Europe and the Asia-Pacific region. Two new overseas offices would be opened in Osaka and Taipei in 1984.

(h) Computerization

The Minister was gratified to report that the Civil Service Computerisation Programme was making good progress. The National Computer Board (NCB), the System and Computer Organisation of the Ministry of Defence and the Institute of Systems Science were carrying out joint research in software engineering.

Computerization in the private sector continued to grow. The NCB estimated that there were about 2,600 firms using computers as compared with 2,000 in 1982. Computer utilization was expected to increase as more companies took advantage of the incentive announced last year which enabled capital expenditure on computers and office automation equipment to be written off in one year.

(i) Manpower development

On manpower development the Minister reported that Singapore was beginning to see an increasing number of trained young men and women coming out from the educational and training institutes. The current shortage of professional, technical and skilled manpower would therefore ease in a few years.

Apart from the increase in number, the realization of training and education plans would bring about significant changes in the quality of Singapore's work force.

As Singapore had benefitted from the influx of talented foreigners who had come to Singapore first to seek work and then make Singapore their home, the Minister emphasized that Singapore would continue with this liberal open-door policy. In particular, those foreign professionals and skilled workers having cultural values compatible with Singaporeans' and who could be easily assimilated into Singapore's society should be welcomed.

(j) Wages

The Minister emphasized that one of the fundamental requirements for success in Singapore's economic restructuring was to ensure that better work was rewarded with better pay. Wages should be determined as much as possible by market forces. The National Wage Council (NWC) had served Singapore well in the past in moderating wage increase at a stage of Singapore's development when she had to compete in the world market on the basis of low wages. As Singapore had to compete on the basis of a skilled, better paid and more productive work force, she must allow market forces to determine her wage level.

Hence, Singapore started last year to move away from the tripartite collective wage negotiations conducted at the national level and instead to promote union-employer wage bargaining at the individual company level. Towards this direction, Government representatives on the NWC played a less active role in determining the wage guidelines.

The Minister, however, warned that while the Government believed in direct bargaining as a way to introduce more market considerations in wage determination, it would be dangerous to rush the process. Direct wage-bargaining would be allowed to evolve in accordance with the readiness of employers and unions.

(k) Productivity

In view of the positive attitudes of Singapore workers towards productivity improvement, the Minister suggested that it was up to employers to respond in kind by better management methods and investments in capital equipment and training. In respect of capital equipment, the Government would provide the necessary tax incentives and financial assistance.

In the 1983 Budget, the Minister had allowed companies to write off in one year expenditure on computers and office equipment. In 1984, he proposed to extend to all sectors the option of accelerated 3-year depreciation of equipment purchased, which was currently enjoyed only by manufacturing enterprises.

(l) Energy and water

The Minister projected that 1984 should see another year of stable energy prices for consumer countries. This would provide favorable conditions for continuing economic growth and low inflation.

1984 Budget Statement

SUMMARY OF TAX CHANGES AND TAX INCREASES

For ease of reference, tax changes and tax increases as announced in the 1984 Budget Statement are summarized below:

I. Tax changes for companies

(a) Accelerated depreciation allowance

With effect from Year of Assessment 1985, all concerns regardless of whether they are manufacturing or non-manufacturing are allowed to claim in respect of new plant and machinery an accelerated allowance of 33⅓% over 3 years. However, this concession is not given to motorcars, motorcycles and light goods vehicles. Computers and office automation equipment will continue enjoying the 100% depreciation in the first year. Presently, only manufacturers are allowed to write off new equipment over 3 years.

(b) Investment allowance

To encourage investment in new technology ventures, entrepreneurs will be able to write off up to 50% of their investments in EDP approved projects, if the project fails to make any cumulative profit during the 3-year period starting from the date of production.

(c) Offshore syndicated loan

The tax exemption benefits for offshore syndicated loans will be extended to syndication of guarantees, performance bonds and certain underwriting facilities such as underwriting bonds, floating rate notes and revolving underwriting facilities.

(d) Financial futures

To help the financial futures market due to start in June 1984, the Singapore International Monetary Exchange (SIMEX) will enjoy tax exemption on its income for 5 years. Corporate and individual members will be taxed at a concessionary rate of 10% for income from transactions with non-residents, Asian Currency Units and other members. Income from transactions with residents will be taxed at 40%.

II. Tax changes for individuals

(a) Personal income tax rate

(i) 10% rebate for Year of Assessment 1984.
(ii) From Y/A 1985 onwards there will be new graduated rates of tax, reducing the tax payable by 11.9% to 13.5% for middle income earners (i.e. those with taxable incomes of $ 10,000 to $ 100,000).

The top rate of 45% for those with taxable incomes of over $ 750,000 will be reduced to 40%.

There will be no change to the tax rates for those with lower incomes (i.e. taxable income of $ 10,000 and below) but they will continue to enjoy a 10% rebate.

(b) Enhanced child relief

With effect from Year of Assessment 1985, enhanced child relief will be extended to all married women who have successfully completed the Secondary School qualification with at least 5 O level passes or those with equivalent qualifications.

Apart from the normal child relief, they can in addition claim:

(i) 5% of their earned income for the *first* child;
(ii) 10% for the *second* child;
(iii) 15% for the *third* child.

In respect of each qualified child, the maximum amount which a specially qualified married woman can claim is $ 10,000.

(c) Estate duty

The current estate duty rates range from 5% to 60%. These will be replaced by a simple two-tier system:
- 5% for the first $ 10 million worth of estate chargeable;
- 10% for amounts over and above $ 10 million worth of assets.

Central Provident Fund balance of a deceased person is tax exempt but if the balance exceeds $ 500,000 no further exemption will be given for other assets (other than those qualified for residential properties).

The above changes take effect from 1 April 1984.

III. Tax increases

(a) Bets

The tax on bets placed on totes of any racing club or association will be raised from 15 to 20% from 1 April 1984.

(b) Cigarettes

The import duties on cigarettes, cigars, cheroots, cigarillos and other tobacco products will be raised to a standard $ 60 per kilogram.

Present import duties range from $ 25 to $ 50 per kilogram.

Excise duty on cigarettes will increase from $ 14 to $ 24 per kilogram. In addition, there is a duty of $ 36 per kilogram on imported leaf tobacco used for the manufacture of cigarettes. Other tobacco products carry a duty of $ 60 per kilogram. Present excise duties range from $ 14 to $ 50 per kilogram.

The above increases are effective from 2 March 1984.

(c) Liquors

Excise duty on beer and stout, from $ 16 to $ 22 per decalitre; on samsoo, from $ 75 to $ 100 per proof decalitre. Import duty on beer, from $ 27 to $ 33 per decalitre; on stout, from $ 39 to $ 45 per decalitre; on samsoo, from $ 130 to $ 155 per proof decalitre.

The above increases are effective from 2 March 1984.

(m) Construction

The Minister reported that the construction industry continued to perform impressively. The public housing programme was proceeding according to plan. With work on the Mass Rapid Transit (MRT) coming on stream, major developments in and around Marina Centre and the accelerated public housing programme, the construction industry would be kept busy again this year.

The Minister warned that the construction industry, however, had a long way to go to catch up with productivity in other sectors. The Government was therefore setting up the Construction Industry Development Board to upgrade the building industry.

Apart from reviewing standards and building regulations to adapt them to industrialized building technologies, the Board would also encourage the private sector to set up factories to produce prefabricated and precast components. In this connection, the Minister reiterated that the Economic Development Board would provide tax incentives for supporting industries manufacturing construction components.

Continuing, the Minister said that another major task was the training of construction workers. Of special significance for the industry was the start of construction on the MRT project in October 1983, a mere one and a half years from the time that the decision to proceed was taken. Implemention of the MRT was timed so as to take advantage of low tender prices arising from the recession. The construction industry, like the other economic sectors, must thrive on free market competition. The Government's role had been and would continue to be a supportive one. Contractors should take advantage of Government incentives and assistance to venture into new building systems.

Concluding remarks on economic policy

In his concluding remarks on economic policy, the Minister said:

> This time last year, I took a gloomy view of the world economy. I noted that protectionism was rising. The international financial system teetered on the brink of a breakdown. The U.S. economy showed no signs of recovery. In the event we performed better than expected. However, notwithstanding the widespread optimism that seems to be the fashion in international financial circles today, I am not yet persuaded that we are out of the woods.
>
> In Singapore we face a serious problem of labor shortage which can set a limit to our growth potential. The repatriation of unskilled and semi-skilled foreign workers from non-traditional sources must go on if we are to succeed in our economic restructuring. This means that future growth can only come from productivity improvement. Singaporeans must therefore work hard and be more productive if we want to continue to better our standard of living. If we do not slacken we can ensure that the growth we achieved in 1983 will continue into 1984.

SECTION II

Expenditure and revenue estimates

In Section II of the Budget statement, the Minister explained that the financial year 1984 Budget was directed towards three objectives:

(a) restraining the increase in Government spending;
(b) encouraging greater efficiency and productivity in companies; and
(c) rewarding individual enterprise and hard work.

The Minister then elaborated on the expenditure and revenue estimates for the financial year 1984.

SECTION III

(1) Revenue

On revenue estimates, the Minister reported that with existing tax rates, recurrent revenue for Financial Year 1984 was estimated at $ 9,969,000,000 which represented a decrease of $ 552,000,000 or 5.2%, compared with the revised estimates of $ 10,521,000,000 for Financial Year 1983.

According to the Minister, projected income tax collection of $ 3,300,000,000 which was $ 169,000,000 or 4.9% less than Financial Year 1983, would account for one third of total estimated receipts for the year. Economic slowdown which continued into the first half of 1983 was given by the Minister as the reason for the decline. Corporate tax payable by those in oil refining, ship repairing, ship building, hotel, manufacturing and commercial sectors would be especially affected.

The total budgetted expenditure of $ 16,561,000,000 for Financial Year 1984 comprised recurrent expenditure of $ 7,567,000,000 and development expenditure of $ 8,994,000,000.

The Minister admitted that even after taking into account Development Fund income of $ 2,670,000,000, the total revenue of $ 12,639,000,000 would be insufficient to finance total recurrent and development expenditure. There would be a deficit of $ 3,922,000,000 which would be financed by public borrowings and a drawing down from the Development Fund.

(2) Tax changes

After dealing with the expenditure and revenue estimates, the Minister announced the following tax changes and tax increases.

(a) Tax changes for companies

The Minister proposed 4 tax changes to stimulate the corporate sector and promote greater efficiency and productivity in economic activities.

Below are extracts of his speech on tax changes for companies:

(i) *Accelerated depreciation allowance*

Manufacturing enterprises are presently allowed to write off their plant and machinery over 3 years. Non-manufacturing enterprises are, however, precluded. I wish to emphasize that all firms should take the necessary steps to automate and upgrade their operations, regardless of whether they are manufacturing or non-manufacturing concerns. I propose therefore to extend the 3-year accelerated depreciation allowance to all plant and equipment in all sectors.

With effect from Year of Assessment 1985, all new equipment will be allowed to claim an accelerated depreciation allowance of 33⅓% over 3 years. Effectively, it means that expenditure on all new equipment can be written off against taxable profits in the 3 years following the year of purchase. In order not to penalize those who have already purchased their equipment, unclaimed residual allowances in respect of existing equipment will also be allowed full set-off in 3 years.

To be consistent with our policy to restrain growth in the number of passenger vehicles, these concessions will not be given to motor cars, motor cycles and light goods vehicles. Computers and office automation equipment will continue enjoying 100% depreciation in the first year.

(ii) *Investment allowance for local companies to invest in new technology projects*

As I mentioned earlier, local companies which invest in approved venture capital projects in new technology industries will be able to write off up to 50% of the equity invested in such projects if the projects incur losses. This will take the form of an investment allowance of up to 50% of the equity investment by those companies which undertake projects approved by the Economic Development Board. A company is defined as a local company if the majority (i.e. more than 50%) of its equity is owned by Singapore citizens or permanent residents.

The investment allowance of 50% will be granted to the investing company only if the new project does not make any cumulative profit during the 3-year period commencing from the expected date of production.

This incentive should encourage our local investors to venture into new frontiers of technological advancement and serve to broaden our present technological base.

(iii) *Extension of offshore syndicated loan tax exemption*

I have also indicated the Government's intention to extend the present tax exemption scheme for offshore syndicated loans to cover other syndicated credit facilities. Specifically, the tax exemption scheme will now include the syndication of guarantees, performance bonds and certain underwriting facilities, such as underwriting of bonds, floating rate notes and revolving underwriting facilities.

All income earned from the syndication of such facilities will be exempt. In the case of underwriting, the tax exemption will not cover income earned by the underwriter arising from the holding of part of an issue that has not been fully subscribed.

In keeping with the scheme for offshore syndicated loans, the tax exemption will be granted to credit facilities which meet certain criteria and are syndicated in Singapore during the 5 years from 1 April 1983. The criteria are essentially similar to those we have at present for offshore syndicated loans. Both schemes can also be extended by the Minister for Finance beyond 31 March 1988.

(iv) *Tax incentive for financial futures market*

The financial futures market will come into operation in June. As this is a new area of financial activity, I have decided to give tax incentives to help the futures market get off to a successful start.

The Singapore International Monetary Exchange (SIMEX) will be given a 5-year tax exemption on its income derived from futures activities.

Income of corporate members which arises from transactions with non-residents, Asian Currency Units and other SIMEX members will be taxed at the offshore concessionary rate of 10%. Individual members of SIMEX will also be able to enjoy this concessionary tax rate. Since futures transactions will be essentially foreign currency transactions, this concession is in line with those given to promote the offshore gold and Asian Dollar Markets. Income arising from transactions with residents will be taxed at 40%.

Market users will be taxed according to the normal tax law. The treatment will vary, depending on the nature and circumstances of each transaction.

(b) Tax changes for individuals

On tax changes for individuals, the Minister announced as follows:

Budget speeches in recent years, including this year, have repeatedly stressed the need to reward individual enterprise and hard work. When individuals succeed, they benefit not only themselves but also society. People must be given the motivation to want to work hard, to better themselves, to invest in new ventures, to take calculated risks. In this Budget I propose to provide the motivation through two major changes:
(a) reduction in personal income tax, and
(b) simplification of estate duty.

In addition, the scheme for enhanced child relief will be improved.

(i) *Personal income tax rates*

Our philosophy on personal income tax rests on 3 basic principles. *First*, personal income tax should never be so high as to become a disincentive to work and enterprise. *Second*, the tax base should be as wide as practicable in order to drive home the message that the cost of services provided by the Government has to be borne by all citizens. The more citizens we have paying tax, even if it is a nominal amount, the more widespread will be the realization that welfare giveaways ultimately carry a price tag. The *third* principle is to ensure that inflation does not push income earners into higher tax brackets. Personal income tax rates should therefore be revised periodically to correct for inflation "creep".

Rates of personal income tax have been reduced 3 times since 1978. As a result, the share of personal income tax collections as a proportion of total income tax collections has declined from 34% in 1977 to 23% in 1982.

The last reduction in personal income tax rates took effect in Year of Assessment 1982. For the Year of Assessment 1984, I have decided to give a rebate of 10% on the tax payable. The rebate of 10% will more than mitigate the erosion of real incomes by inflation which, according to the Consumer Price Index, rose by 5% between 1981 and 1983.

For Year of Assessment 1985, the existing rates of personal tax will be reduced. I would like to table a schedule showing the revised income tax rates (Appendix I).

In the revision of tax rates, I have paid special attention to the middle income groups whose chargeable incomes fall between $ 10,000 and $ 100,000. They will enjoy average reductions in income tax ranging from 11.9 to 13.5%. The highest marginal rate has been reduced from 45 to 40% giving reductions of between 8.4 and 9.8% for our biggest tax payers.

The rates of tax for the first 3 chargeable income groups, that is, up to chargeable income of $ 10,000, are, in my view, already low enough and will not, therefore, be changed. Instead, I intend to give a flat rebate of 10% on the tax payable in respect of the first $ 10,000 of chargeable income for Year of Assessment 1985 and future years.

(ii) *Estate duty*

In the Budget debate last year some Members pointed out that the present structure of estate duty is not consistent with Government's philosophy of encouraging people to work hard and save.

With the Government taking away a big chunk of what the taxpayer has worked so hard in his lifetime to accumulate, the Members felt that it would be more sensible for the taxpayer to spend his income rather than let the Government take it away when he dies.

The present system of estate duty therefore encourages consumption and discourages saving.

I informed Members then that the Ministry of Finance was in the process of reviewing the whole rationale of estate duty and I promised to let Members have more information this year.

I am pleased to inform Members that the Ministry of Finance has completed its analysis and the structure of estate duty will be substantially simplified.

First, there will only be two rates of duty. The first $ 10,000,000 in value of estate chargeable to duty will be taxed at 5% and all subsequent amounts at 10%. This two-tier rate of duty will replace the existing complicated system of remission and taxation with tax rates ranging from 5 to 60%.

Second, the exemption limit for residential properties will be revised to $ 3,000,000 irrespective of the number of residential houses which the deceased owned.

Third, the full Central Provident Fund (CPF) balance of the deceased will continue to qualify for exemption. Where the CPF balance exceeds $ 500,000, no further exemption will be given for other assets except for those which qualify for exemption as residential properties.

Where the CPF balance does not exceed $ 500,000 the maximum exemption that will be given for other assets including CPF balance will be $ 500,000.

The period governing inter vivos gifts will remain at 5 years. Gifts made within 5 years preceding the date of death will be liable for estate duty.

With these revisions in the structure of estate duty, it should be unnecessary for the vast majority of our taxpayers to worry at all about estate planning to minimize estate liabilities.

The above concessions will take effect from 1 April 1984.

(iii) *Enhanced child relief*

Last year I increased the enhanced child relief for specially qualified married women to be the normal child relief plus 5% of the woman's annual earned income for each of the first 3 eligible children.

This provoked a lively debate among Members. Some felt that the relief was "peanuts" and unlikely to persuade highly qualified married women to continue to work and give society the benefit of their talents and abilities. Others suggested that the relief should be extended to all working women or, at the very least, to those categories of married working women who have some form of tertiary training and education although this might not be at the University level.

In my reply I stated that I was not convinced that there was a case to extend the enhanced child relief to all working women but there might be merit in the suggestion to widen slightly the present narrow range of qualifications which would entitle married working women to claim the enchanced child relief.

I have considered the matter further and have now come to the conclusion that a somewhat more liberal scheme can be justified not only induce our better educated married women to continue to work but, more important, to encourage them, hopefully, to have a second, if not a third child. This will go a little way towards correcting the present lop-side pattern of procreation in Singapore which is a cause for concern.

I have therefore decided that, with effect from Year of Assessment 1985, the enhanced child relief will be increased to the following amount:

For the *first* qualifying child: Normal child relief plus 5% of annual earned income or $ 10,000, whichever is less.

For the *second* qualifying child: Normal child relief plus 10% of annual earned income or $ 10,000, whichever is less.

For the *third* qualifying child: Normal child relief plus 15% of annual earned income or $ 10,000, whichever is less.

Furthermore the enhanced child relief will be extended to all married women who have successfully completed their secondary school education with at least 5 "O" level passes or who possess equivalent or higher qualifications. This will cover about one third of our female working force.

(3) Tax increases

Finally, the Minister announced tax increases and below are extracts from his speech.

Our overall tax philosophy has been to shift the burden of taxation from personal income tax to tax on consumption particularly on items which cannot be regarded as comprising the necessities of life. In line with this philosophy I intend to increase the duties on bets, cigarettes, beer, stout and samsoo.

(i) *Duty on bets*

The present duty on bets is 15% on the amount of bets placed on any totalizator or pari-mutuel promoted by any racing club or association. The duty was last revised on 1 April 1981. It will be further increased to 20% with effect from 1 April 1984.

(ii) *Duties on cigarettes and tobacco*

Duties on cigarettes and tobacco were raised last year in pursuit of our objective to discourage smoking, particularly among our younger population. Consumption was dampened for a few months but quickly picked up and, in December last year, consumption of cigarettes and tobacco reached an all-time high. However, we must persevere in this noble cause and not give up. This year I propose to raise the import duty on cigarettes, cigars, cheroots, cigarillos and other tobacco products, which are now at varying rates, to a uniform $ 60 per kilogram. The excise duty on cigarettes will be increased from $ 14 per kilogram to $ 24 per kilogram.

Excise duty on cigarettes is payable in addition to the duty of $ 36 per kilogram on imported leaf tobacco which is used for the manufacture of cigarettes. Excise duty on other tobacco products will be fixed at $ 60 per kilogram. Details of the revision are set out in Appendix II.

The revision in duties will take effect from today (2 March 1984).

(iii) *Duties on liquors*

Excise duties on beer, stout and samsoo have not been raised since 1975. Import duties on beers and samsoo were last raised in 1977 and import duty on stout in 1980.

With effect from today (2 March 1984) the excise duties on beer and stout will be increased by $ 6 to $ 22 per decalitre while the excise duty for samsoo will be raised from $ 75 per proof decalitre to $ 100 per proof decalitre. Import duty on beer and stout will also be raised by $ 6 per decalitre to $ 33 per decalitre and $ 45 per decalitre respectively, while import duty on samsoo will be raised by $ 25 per proof decalitre to $ 155 per proof decalitre. Details of the revision in import and excise duties on beer, stout and samsoo are listed in Appendix III.

(4) Duties on motor cars

On duties on motor cars, the Minister gave the following warning:

Members will know that one of Government's objectives is to restrain the growth of the motor car population in Singapore in order to contain the problem of congestion on our roads. I had considered increasing registration fees and road tax in this Budget but eventually decided not to do so in view of the substantial increases announced in October last year.

The Minister, however, expressed the hope that the decrease in personal income tax rates, which he announced earlier, would not lead to an upsurge in purchases of motor cars. He warned that should this happen, the Government would have to review the situation and make adjustments accordingly.

CONCLUSION

In conclusion, the Minister said:

Steering the economy of a nation is a delicate exercise. Holding the brakes full on means there is no progress. On the other hand if you press the accelerator too hard you may end up in the gutter. The trick is to be able to read the weather signs correctly and proceed at a pace which will satisfy the natural aspirations of our people, but which will not result in a nasty crash.

One consistent theme has recurred: the importance of manpower development, education, training and management-labor cooperation. While the slogans may be new, the theme merely reflects the self-evident truth that Singapore's only resource is her people. How well we utilise our manpower will determine how much progress we can make and how prosperous we will be in the future.

The economic policies and tax changes which I have outlined today are designed to keep up the momentum of our progress. It will be too much to hope that no new problems lie ahead. Problems and dangers there must be but, provided we do not slacken in our effort and we work together, we will surmount them.

APPENDIX I

Individual income tax reduction under revised rates schedule from year of assessment 1985

Chargeable income group – $	*YA 84 Existing rates – %*	*YA 85* Revised rates – %*	*Average tax paid at existing rate*	*Average reduction in tax $*	*%*
1 – 5,000	4	4	96	10	10.0
5,001 – 7,500	7	7	279	28	10.0
7,501 – 10,000	9	9	479	48	10.0
10,001 – 15,000	12	10	863	103	11.9
15,001 – 20,000	14	12	1,515	205	13.5
20,001 – 25,000	17	15	2,289	306	13.4
25,001 – 35,000	21	18	3,694	495	13.4
35,001 – 50,000	25	22	6,482	856	13.2
50,001 – 75,000	30	26	11,766	1,534	13.0
75,001 – 100,000	32	29	19,640	2,442	12.4
100,001 – 150,000	35	31	31,396	3,694	11.8
150,001 – 200,000	35	34	49,232	5,078	10.3
200,001 – 400,000	40	37	83,264	7,113	8.5
400,001 – 750,000	43	39	190,349	16,067	8.4
Above 750,000	45	40	529,491	52,015	9.8

* From YA 85 onwards, a 10% rebate on the tax payable of up to the first $ 10,000 of chargeable income will be given for each year of assessment.

APPENDIX II

Duties on cigarettes and tobacco

CCCN No.	Description	Existing import duty	Existing excise duty	New import duty	New excise duty
24.02 100	Cigars, cheroots and cigarillos	$ 50 per kg	$ 50 per kg	$ 60 per kg	$ 60 per kg
24.02 200	Cigarettes	$ 50 per kg	$ 14 per kg	$ 60 per kg	$ 24 per kg
24.02 400	Snuff	$ 40 per kg	$ 40 per kg	$ 60 per kg	$ 60 per kg
24.02 810	Other manufactured tobacco: Packed for retail sale	$ 30 per kg	$ 30 per kg	$ 60 per kg	$ 60 per kg
24.02 820	Not packed for retail sale: Pipe tobacco (bulk)	$ 25 per kg	$ 25 per kg	$ 60 per kg	$ 60 per kg
24.02 899	Tobacco not elsewhere specified or included	$ 36 per kg	$ 36 per kg	$ 60 per kg	$ 60 per kg

APPENDIX III

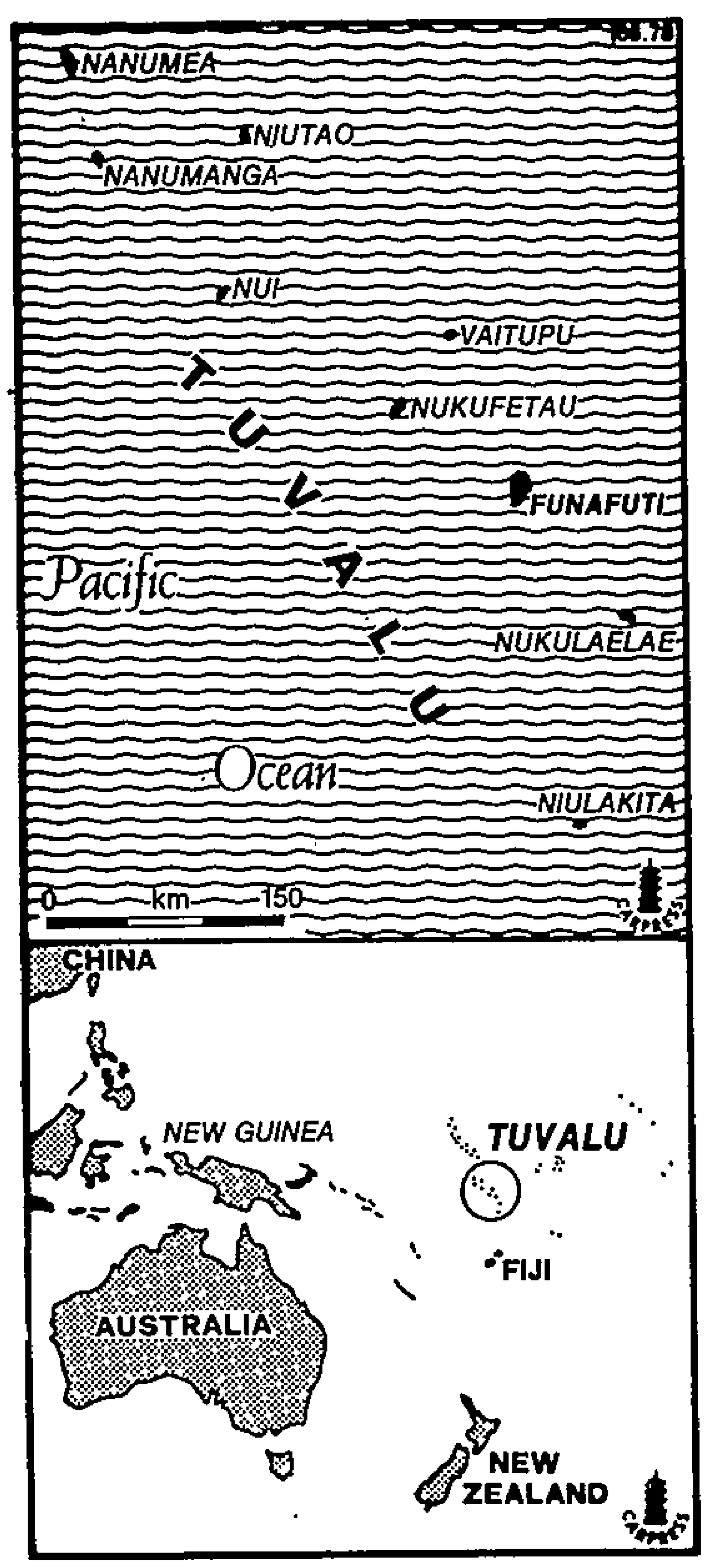
Duties on liquors

CCCN No.	Description	Existing import duty	Existing excise duty	New import duty	New excise duty
22.03 100	Beer made from malt: Beer and ale	$ 27 per dal	$ 16 per dal	$ 33 per dal	$ 22 per dal
200	Stout and	$ 39 per dal	$ 16 per dal	$ 45 per dal	$ 22 per dal
22.09 600	Samsoo, including medicated samsoo	$ 130 per proof dal	$ 75 per proof dal	$ 155 per proof dal	$ 100 per proof dal

The Tax System of Tuvalu

A Brief Survey

By Eugen Jehle



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Mr. Jehle is senior research associate of the International Bureau of Fiscal Documentation

I. INTRODUCTION

1. General information[1]

Tuvalu, formerly known as the Ellice Islands, has been an independent state since 1 October 1978. It is situated in the South Pacific and comprises 9 atolls or coral islands. Tuvalu is a member of the British Commonwealth as well as a member of various organizations and signatory to agreements of economic significance, including the South Pacific Economic Commission, the Lomé Convention, and the SPARTECA Agreement.

The land area of Tuvalu is about 26 square kilometers; the ocean area that belongs to Tuvalu is about 1.3 million square kilometers. Funafuti is the capital of Tuvalu.

The legislative authority (including tax matters) is the Parliament which consists of 12 members who are elected by popular vote. The sessions are also attended by the Attorney General.

2. Fields of economic interest in Tuvalu[2]

The fields of economic interest for potential foreign investors are, of course, determined by Tuvalu's geographical situation. Given Tuvalu's vast ocean area, it appears that, in the long run, exploitation of the sea resources will play a significant role which would include fishery and deep sea mining. The development of such activities will most probably take place on the basis of regional cooperation and/or in cooperation with enterprises of industrialized countries that avail of the pertinent technology.

The further development of agriculture is limited due to the poor quality of the soil, and will basically be confined to furthering the production of copra which is already the major export crop. At the same time, the subsistence farming of coconuts and pig and poultry rearing will be maintained. The development of tourism is also regarded as an aim in the longer run; Tuvalu's remoteness and the lack of hotel facilities currently represent the major obstacles for a quick upturn in this field.

II. THE DIFFERENT TAXES OF TUVALU[3]

1. The income tax

(a) General observation

The Income Tax Law[4] of Tuvalu governs the taxation of both companies and individuals. Thus, differences occur, roughly speaking, only as a result of the very nature of this tax, e.g. in a different tax rate to be applied, taking into consideration a basic exempt amount for individuals.

As far as internationally important aspects of the Income Tax Law of Tuvalu are concerned, the following is observed:

– Tuvalu is a party to bilateral tax treaties with the following countries:
Denmark, 18 November and 22 December 1954 (extension of treaty between Denmark and the United Kingdom, of 27 March 1950); entry into force: 1 January 1954.
Norway, 18 May 1955 (extension of treaty between Norway and the United Kingdom of 2 May 1951); entry into force: 1 January 1955.
Sweden, 19 January 1972 (extension of treaty between Sweden and the United Kingdom, of 28 July 1960); entry into force: 1 January 1972.
United Kingdom, 10 May 1950, amended by supplementary arrangements of 4 March 1962 and 25 July 1974.

1. For an English language survey containing general information on Tuvalu, see: J. Carter (ed.), *Pacific Island Yearbook* (Pacific Publications, Sydney and New York).
2. General information on investment opportunities in Tuvalu is available from: Ministry of Commerce and Natural Resources, Vaiaku, Funafuti Island, Tuvalu, South Pacific. Cable address: MINCOM, FUNAFUTI.
3. The author would like to express his sincere thanks to Mr. J.B. Atkinson, Attorney-General, Government of Tuvalu, Vaiaku, Funafuti Island, Tuvalu, for his kind assistance in checking the draft of this article.
4. An ordinance (No. 11 of 1982) to impose a tax on income and to provide for the collection and management of the tax (December 1982).

- In all other cases, the unilateral measures for avoidance of double taxation are applied. They provide for a tax credit for foreign-source income that was subject to a foreign income tax, whereby the actual credit is confined to the amount of Tuvalu income tax due on that part of income.

(b) Company income tax[5]

A company that is incorporated or registered under any law in force in Tuvalu (i.e. a resident company) is subject to income tax on its world-wide income. Partnerships are not regarded as companies for tax purposes; their income is taxed in the hands of the partners on a pro rata basis.

A taxable person (other than an individual) is regarded as a resident of Tuvalu if a substantial part of the control and management of its affairs is exercised in Tuvalu in the relevant year.

Non-resident companies are subject to Tuvalu income tax on their Tuvalu-source income.

Taxable income is divided into 6 categories; for companies it comprises profits from any kind of commercial undertaking, including any amount of money received under any insurance against loss of profits, any recovery of previously written-off items, and any income that is received after the cessation of a business to the extent that it also would have constituted taxable income prior to the cessation.

Exemptions are, inter alia, provided for the income of cooperative societies registered under the Co-operative Society Ordinance, the income of the National Bank of Tuvalu, and any income arising from the sale of copra.

The year of assessment and accounts is usually the calendar year, but deviations may be applied for.

Depreciation of fixed assets takes place following these principles:

Type of asset (depreciable item)	Year of acquisition of the asset	Year(s) following the year of acquisition of the capital asset
ships	50%	10%
machinery and plants	50%	25%
buildings	25%	10%

The chargeable income of a company is subject to income tax at the flat rate of 25%.

(c) Individual income tax[6]

Resident individuals are subject to income tax on their world-wide income. Non-resident individuals are subject to Tuvalu income tax on their Tuvalu-source income.

A distinction is made between 6 types of income, namely:
- income from business;
- income from employment and services;
- income from rent;
- income from dividends, interest, and discounts;
- income from pensions, charges, annuities and alimony;
- any other income declared as being taxable according to the underlying legislation.

It should be noted that with respect to income from employment, income tax is usually withheld by the employer applying a pay-as-you-earn scheme.

Various items are exempt from income tax, including war pensions, certain compensation payments, payments from the Tuvalu Provident Fund, and all income arising from the sale of fish and copra if that sale is effected within Tuvalu.

Individuals are subject to income tax at the flat rate of 30%; however, a basic exempt amount of $2,500 per taxpayer is provided.

2. Sales tax[7]

Since 1 January 1983, a sales tax is levied in Tuvalu on the transfer of any kind of goods and livestock within Tuvalu, and any imported item. The transfer of real property does not represent a taxable transaction. A person who carries on taxable transactions is liable for that tax. In the case of imports, the taxable person is identical with the person liable for payment of the import duty. No sales tax is levied in those cases where the annual turnover derived by one person through a manufacturing process does not exceed $5,000.

A number of items are exempt from the sales tax, including the import of rice, flour, bar soap, kerosene and goods imported for the production or sale of stamps.

The taxable base is the value of the goods transferred.

Sales tax is levied at the uniform rate of 5%.

3. Customs duties[8]

Tuvalu charges customs duties on many imported items and a few export products.

(a) Import duties

Import duties are levied on the basis of a list of items that is divided into 10 sections:

Section items	*Tariff (span)*
0 food	0-50%
1 beverages and tobacco	0-30% (most refer to quantity)
2 crude materials, inedible	0-20% (for salt: quantity)
3 mineral fuels, lubricants and related materials	0-20% (some refer to quantities)
4 animal and vegetable oils and fats	20%
5 chemicals	0-50% (some refer to quantity)
6 manufactured goods, classified chiefly by material	0-50%
7 machinery	0-50%
8 miscellaneous manufactured articles	0-50% (some refer to quantities)
9 miscellaneous transactions and commodities	(mostly free)

5. See note 4.
6. See note 4.
7. An ordinance (No. 12 of 1982) to impose a sales tax and to provide for its collection and management (December 1982).
8. The Customs Duties Ordinance, 1963, First Schedule, Section 7.

Items that are exempt from duties include: airport ground equipment; containers; coverings, packages, etc; cultural and educational articles; health aids and goods for the relief of the permanently disabled, etc.; H.M. Government; the Governor; legacies, etc.; marine and port equipment and boat and lifesaving equipment; mining machinery; patterns, samples, advertising matter and documents; scientific and meteorological research; U.N. organization and agencies; South Pacific Commission and South Pacific Air Transport Council; equipment for agricultural, forestry and stock control purposes.

(b) Export duties

Export duties are currently (1 October 1983) levied on:

Item	*Tariff*
copra	20% of balance of f.o.b. value above $75 per tonne
copra (n.e.s.)	20% of f.o.b. value
ferrous materials	$3 per tonne
non-ferrous materials	15% ad valorem

Note: Tuvalu is a signatory to the Lomé Convention which, inter alia, provides for preferential treatment of exports from Tuvalu to E.E.C. member states (i.e. no custom duties for most commodities).

Tuvalu is also a signatory to the SPARTECA Agreement which provides for a preferential access of Tuvalu products to the markets of Australia and New Zealand.

4. Registration fees[9]

Tuvalu charges registration fees for the registration of companies, whereby a distinction is made between resident and non-resident companies and businesses. The fees are as follows:

Document	*Fee ($)*	
	Residents	*Non-residents*
Certified copy of document relating to constitution of company or business	5.00	10.00
List of directors or partners and persons authorized to accept service	1.00	2.00
Alteration in either of the above	1.00	2.00
Annual balance sheet	2.00	4.00

III. TAX INCENTIVES FOR INVESTMENT IN TUVALU[10]

Upon application, the Minister of Finance may grant an entrepreneurial undertaking "pioneer business" status. The application must contain the following information:

– the nature of the business which it is proposed that the person shall commence;
– a detailed estimate of the benefits to the economy to be expected from such business;
– the estimated amount and purpose of the capital to be employed in the business and the sources from which that capital will be obtained;
– the conditions under which workers will be employed, their numbers and provisions for their housing;
– evidence that the business venture will be provided with effective and competent management; and
– such other particulars or information as the Minister may require.

Where the Minister is satisfied, he releases an order in which he indicates all details referring to the "tax concession period"; at any rate, it lies in the discretion of the Minister to determine the precise volume and duration of the tax concessions.

9. An ordinance (No. 2 of 1978), The Companies and Business Registration (Fees) Regulations 1979.
10. As note 4, Section 11, Schedule II.

Budget 1984-85

See for a detailed description of the Indian tax system the publication of the International Bureau of Fiscal Documentation: *Taxes and Investment in Asia and the Pacific.*

On 29 February 1984, the Minister of Finance, Mr. Pranab Mukherjee, presented his 1984-85 Budget to the Indian Parliament. This Budget has been described as a pre-election Budget which contains more that is good than is bad.[1] In any case a large number of taxpayers will receive some relief and the loss of revenue will to a large extent be compensated by an increase of customs duties.

Mr. Kailash C. Khanna, the Bulletin's correspondent in India, kindly sent us a summary of the proposed measures.

DIRECT TAXES

1. The rates of income tax for individuals are to be revised. The existing and proposed rates are shown below:

Income (Rs.)	*Existing rates (%)*	*Proposed rates (%)*
Up to 15,000	Nil	Nil
15,001 – 20,000	25	20
20,001 – 25,000	30	25
25,001 – 30,000	35	30
30,001 – 40,000	40	35
40,001 – 50,000	40	40
50,001 – 60,000	50	45
60,001 – 70,000	52.5	45
70,001 – 85,000	55	50
85,001 – 100,000	57.5	50
Over 100,000	60	55

The surcharge of 12.5% on income tax will continue. The maximum marginal rate, inclusive of the surcharge, will be reduced from 67.50 to 61.875%.

2. It is proposed to grant an option to companies to deposit the entire surcharge on corporate tax (5%) with the Industrial Development Bank of India, instead of only 2.5%. These resources will flow back to the corporate sector and will be available for modernization of Indian industry.

3. The tax exemption granted to tea companies with respect to subsidies received will be extended. The existing provisions contain an exemption from tax only for subsidies received for replanting and replacement of tea bushes. Henceforth subsidies for other approved schemes will also qualify for exemption, such as schemes for rejuvenation and consolidation of areas.

4. It is proposed to withdraw tax relief available under the following section of the Indian Income Tax Act:

– Sec. 33B: rehabilitation allowance granted under certain circumstances to businesses which have suffered extensive damage because of specified calamities;
– Sec. 35C: agricultural development allowance;
– Sec. 80CC: deduction for investment in certain new shares;
– Sec. 80D: deduction for medical treatment of handicapped dependents;
– Sec. 80E: deduction for payments for securing annuities.

5. It is proposed to reduce the amount of the tax exemption available under Secs. 80M (inter-corporate dividends), 80N (dividends received from certain foreign companies) and 80O (royalties, etc. received from certain foreign companies).

6. In order to curb the tendency to inflate expenditure, the withdrawal of weighted deductions available under the different provisions of law is suggested. The expenditure actually incurred will continue to qualify for deduction but the benefit of weightage will no longer be available.

7. It is proposed to disallow retrospectively from 1980/81 any sums paid by an employer to any welfare fund or trust other than statutorily recognized funds.

8. It is planned to impose income tax on charitable and religious trusts circumventing the law, i.e. which carry on a business.

9. It is proposed to raise the upper limits for tax-deductible managerial remuneration from 72,000 Rs. to 102,000 Rs. and from 60,000 Rs. to 90,000 Rs., per annum.

10. It is suggested that, henceforth, widely held companies may pay interest on debenture and dividend income, up to 1,000 Rs. to resident individuals without deduction of tax at source, provided the payment is made by cheque or bank draft.

11. It is suggested that loans or deposits of 10,000 Rs. or more be taken or accepted, by crossed cheque or bank draft.

12. Compulsory audit of accounts is suggested in all cases where the annual turnover exceeds 2,000,000 Rs. or where the gross receipts from a profession exceed 1,000,000 Rs.

13. For wealth tax purposes, it is proposed to raise the monetary ceiling of exemption in respect of one house owned by the taxpayer from the existing 100,000 Rs. to 200,000 Rs. It is also proposed that the exemption limit of specified financial assets be raised from 165,000 Rs. to 265,000 Rs.

14. It is proposed to provide that a charitable or religious trust will forfeit tax exemption under the Wealth Tax Act if the funds of the trust are not invested in accordance with the investment pattern laid down under the Income Tax Act. Further such trusts would be liable to wealth tax at the maximum marginal rate of 5%.

1. *Business Standard,* 1 March 1984 at 7.

INDIRECT TAXES

The effective rate of the auxiliary duty of customs will be raised by 5 percentage points, with the exception of some essential items like fertilizers, bulk petroleum products such as kerosene and high speed diesel oil, and newsprint.

The basic customs duty on different items of iron and steel (other than stainless steel) will be raised by 5 or 10 percentage points, depending upon the existing rates.

A total customs duty of 20% ad valorem will be levied on stainless steel melting scrap (currently exempt).

The import duty on zip fasteners, magnetic tapes and special petroleum products will be increased.

To promote exports of gems and jewellery, the customs duty on processing and manufacturing machines will be reduced from existing rates to 40% ad valorem.

A total exemption from customs duty on wood chips for manufacture of paper and board will be available as well as a reduction of duty on wood pulp imported for manufacture of paper from the existing level to 30%.

The customs duty on specified machines for packaging of meat and food processing will be reduced to 40% ad valorem.

Khandsari sugar is to be fully exempt from excise duty.

The rates of the basic excise duty on printing and writing paper will be reduced by 425 Rs. per tonne.

Recorded cassettes will be exempt from excise duty.

The excise duty on polyester blended cotton cloth will be reduced by 5 Rs. per kg. However, the polyester blend should not be more than 70% and less than 40% for this purpose.

Handloom and powerloom cloth of certain categories will be fully exempt from excise duty.

The additional excise duty will be increased from 7.5 to 10% on man-made fabrics of assessable value exceeding 25 Rs. per sq. metre. The impact will be on costlier fabrics.

The existing concession is to be continued on refrigerators, freezers and domestic appliances.

The duty on table fans will be reduced from 10 to 5% and on ceiling fans up to 117 cm, from 15 to 7.5%.

The excise duty on china and porcelain will be reduced from 30 to 15%.

The excise duty on water coolers will be reduced from 40 to 30% ad valorem.

The excise duty on electricity will be abolished from October 1984.

More details on the 1984-85 Indian Budget were published in 2 *Asian-Pacific Tax and Investment Bulletin* (1984).

In next issues:

Thailand: Loss companies
– by *M. Hongskrailer & K.S. Jap*

Botswana: 1984 Budget Speech
– by *Bernadette P. Davey*

Botswana: 1984 Budget Speech

Taiwan: Prospects of the Taipei offshore banking center
– by *I-Shuan Sun*

The 1984 income tax changes in the Republic of South Africa
– by *Dr. Erwin Spiro*

South Africa: Budget 1984-85

Hong Kong's new revenue proposals and their implications
– by *Y.C. Jao*

Tax havens in the Caribbean Basin

Morocco: Foreign investment regulations
– by *Servaas van Thiel*

U.S.S.R.: The 1984 Budget Act and the tax system
– by *Prof. Dr. Tibor Nagy*

Japan: The 1984 tax amendments
– by *Makoto Miura*

OECD: The taxation of income derived from the leasing of industrial, commercial or scientific equipment

EEC: The Future Financing of the Community[1]

– A new Commission proposal –

The Commission proposed in May 1983 that under the 1970 Decision on own resources a new Community decision-making procedure should be instituted for setting the rate of call-up applicable to the basis of assessment for VAT.

The procedure would be operated for the first time before the setting of a VAT call-up rate above 1.4%.

The Commission's proposal received the support of the European Parliament, with the qualification that the matter must be dealt with in the framework of the powers pertaining to national ratification procedures. From the Council discussions it emerged that the overwhelming majority of the Member States wished to continue the principle of a ceiling rate laid down in the 1970 Decision and the requirement that any increase in the ceiling rate is to be agreed by the Member States unanimously and ratified by the national Parliaments.

This being so, the Commission would now make the point that the Community is consequently in the same position as at the time of the 1970 Decision; the Community has accordingly to set a new ceiling on the increase of VAT own resources.

The 1970 Decision gave the Community financial security for thirteen years.[2]

A decision of like scope is called for now, taking account of a number of considerations that did not apply when the 1970 Decision was taken.

1. Future development of the Community Budget in the context of budget discipline

Raising the own resources ceiling is this time part and parcel of a set of arrangements proposed by the Commission for containing farm spending and establishing strict budget discipline generally.

The strict budget management guaranteed by the decision which the Council takes on the basis of the Commission's proposals will ensure that the new resources are of a permanent nature by enabling the growth of the Community Budget to be kept within bounds.

At the same time the European Council's decisions on the future financing of the Community must show a dynamic approach and offer a real prospect of further development in the medium term.

For there are cases where joint action by the Member States is more effective and economical than piecemeal national measures. With all due respect for the constraints on public spending throughout the Community, the financing system of the Community must therefore be given sufficient flexibility to take on further developments in line with these economy requirements, particularly as they mean in practice that the demands on the national Budgets are less.

2. Enlargement

The raising of the own-resources ceiling must also enable the Community Budget to cover the financial implications of Spanish and Portuguese accession.

The annual profile of the budgetary effects of enlargement cannot be determined at the present stage of the negotiations with Spain and Portugal. To start with the increase in Community expenditure will stem mainly from higher structural expenditure for the benefit of the acceding countries and the Mediterranean regions of the Community; later on enlargement might involve a *net* increase in the Community Budget of 0.1-0.2% of VAT.

3. Rate of growth of own resources

Prudence demands that we should not bank on a real growth rate in Community GDP of more than 2.5% p.a. over the coming years.

The average annual growth in the VAT basis of assessment should not exceed that in GDP. Moreover, the trend in movement of the other revenues is sluggish: in fact in real terms their value has actually declined.[3]

In 1978, customs duties and the other common policy-related revenues accounted for 45% of available own resources, but in 1984 the figure is only 42%.

This trend can be expected to continue, and indeed to gather pace, in the years ahead. Most customs duties are bound in GATT and come under a dismantling schedule which could be speeded up in accordance with the progress of world efforts to liberalize international trade.

As for the agricultural levies, they are a particularly erratic source of finance whose yield will be adversely affected by the implementation of the Commission's proposed CAP reforms.

Care must be taken therefore not to equate an increase in the Community Budget with an increase in the VAT revenues required. The relative diminution in the other resource automatically involves, for a given real increase in the Budget, a faster increase in the VAT revenues called

1. Communication from the Commission to the Council, Doc. 5 March 1983 (COM (84) 40 final). See for the EEC "Green Paper" on this subject, 37 *Bulletin for International Fiscal Documentation* 11 (1983) at 497.
2. Whereas in 1981 the VAT call-up rate was still the same as in 1979, viz. 0.78, it suddenly moved to over 0.9. Since 1983 the Community Budget has been up against the own resources ceiling, as the combined result of farm spending and offset payments to correct the imbalances in the distribution of budget charges. (Had it not been for the offset payments the 1983 call-up rate would have been 0.875.)
3. The traditional own resources (agricultural levies, sugar and isoglucose levies, customs duties) rose in face value by an average 6.8% p.a. in the period 1978-83, while during the same period GDP implied prices rose by 8.9% p.a. The real value of the traditional own resources thus fell by an average 1.9% p.a. during those five years.

up. Thus it has been estimated that tariff dismantling and the fall in the agricultural levies consequent on CAP reform could mean, at a time-scale of 10-15 years, a 0.2% increase in the VAT call-up rate merely to maintain the real value of available own resources.

4. Time needed

To gain the Council's agreement to a proposal for going above the own-resources ceiling, and after that to obtain ratification by the national Parliaments (twelve of them after enlargement), will take at least two years. This cuts two years off the period during which the higher own resources ceiling will allow trouble-free Community budgeting.

Moreover the credibility of the Community system would suffer severely if the national Parliaments had to be constantly applied to in order to obtain the wherewithal to go ahead with the common venture.

In the two financial years that will elapse between the exhaustion of own resources within the 1% ceiling and the advent of the new resources Budget growth will be completely straitjacketed. Hence there is bound to be an accumulation of commitments and deferments of expenditure which will have to be honoured later. This is inevitable even if the Commission's proposals for the reform of the CAP are adopted in full in principle by the Brussels European Council in March, for even then it would still take time to turn the decisions-in-principle into operational regulations, and time again for the regulations to have their full budgetary impact. So it could be that the Community Budget will have to be temporarily increased for so long as it takes to implement the arrangements for properly containing farm spending. This factor, which may be discounted in a long-term context, would become very relevant indeed if the new own-resources ceiling were not consonant with the long-term context and in fact only afforded the Community a breathing-space.

* * *

5. In view of the foregoing the Commission is proposing that the Council today take a decision of like importance to that of 1970, raising by one point the maximum rate determining the revenue from value-added tax which may be assigned to the Community.

The Commission is of the opinion that this increase of the ceiling rate from 1 to 2% of the basis of assessment for VAT would give the Community secure financing for long enough to cover the whole transitional period of its enlargement to include Spain and Portugal.[4]

In asking the European Council to give the Community this financial security – monitored in accordance with the budget discipline rules – it is thus asking the Member States to have the same degree of confidence in Europe as they did in 1970.

It is not asking them to accept the principle of automatic, regular increases in Community revenue-generation.

By deciding to make available to the Community a certain range of potential resources the Member States will not be authorizing their deployment; the actual expenditure and revenue of the Community will be determined through the annual Budget procedure, strictly within the frame-work of the rules on budget discipline proposed by the Commission.

Development of the Community Budget and funding thereof
(some significant points) 1978-83

Total expenditure	
As a % of Community GDP, 1978	0.79%
1983	0.93%
As a % of national Budgets, 1978	2.6%
1983	2.8%
Real annual average growth rate	5.8%
VAT	
Rate of real annual average growth in basis of assessment for VAT 1979-83	1.9%
Rate of real annual average growth in VAT revenues collected 1979-83	8.9%
VAT call-up rate 1979	0.7781
VAT call-up rate 1983	0.9980
Other resources	
Rate of real annual average in agricultural resources	− 8.0%
Rate of real annual average growth in total customs duties	+ 0.8%
Rate of real annual average growth in total other resources	− 1.9%

4. During that period it is also necessary to allow for the effects, at the appropriate time, of budgetizing the EDF.

UNITED STATES:
Foreign Tax Credit

Final Internal Revenue Service Regulations (T.D. 7918) on creditability of foreign taxes, filed 6 October 1983 (extracts)

This document contains the final regulations setting forth the conditions that must be met in order for a levy imposed by a foreign country or a possession of the United States to qualify as an income, war profits, or excess profits or a tax in lieu of such a tax otherwise generally imposed. They supersede the regulations published in the Federal Register on 17 November 1980. The new Regulations are effective for taxable years beginning after 14 November 1983. Taxpayers may, however, elect to apply the Regulations to earlier open taxable years.

BACKGROUND

On June 1, 1978, the Legislation and Regulations Division of the Office of Chief Counsel of the Internal Revenue Service opened a regulations project for the purpose of promulgating regulations that would give taxpayers greater guidance with respect to the creditability of foreign taxes under sections 901 and 903 of the Internal Revenue Code. On August 28, 1978, a notice was published in the FEDERAL REGISTER (43 FR 38429) inviting public comments on the creditability of foreign taxes and recommendations for the regulations. A Notice of Proposed Rulemaking was published on June 20, 1979 (44 FR 36071), and a public hearing was held on October 11, 1979. On November 17, 1980, temporary and proposed regulations were published (45 FR 75647 and 45 FR 75695, respectively) and a public hearing was held on May 28, 1981. On April 5, 1983, another Notice of Proposed Rulemaking was published (48 FR 14641) and a public hearing was held on June 23, 1983. After consideration of all comments received on the proposed regulations of April 5, 1983, the regulations, with revisions, are adopted by this Treasury Decision.

DISCUSSION

§1.901-2

Section 901 allows a credit for the amount of income, war profits, or excess profits taxes paid or accrued by or on behalf of a taxpayer to a foreign country or possession of the United States. A foreign levy is a creditable tax only if it is a tax and its predominant character is that of an income tax in the U.S. sense.

A levy is a tax under these final regulations if it requires a compulsory payment pursuant to the foreign country's authority to levy taxes. A payment for a specific economic benefit (defined in §1.901-2(a)(2)(ii)(B)) is not a tax. A taxpayer who directly or indirectly receives a specific economic benefit from a foreign government (a "dual capacity taxpayer") must establish under §1.901-2A the portion, if any, of his payment to the foreign government that is a payment of tax.

Under these final regulations, the predominant character of a foreign tax is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances in which it applies. This standard, found in §1.901-2(a)(3)(i), adopts the criterion for creditability set forth in *Inland Steel Company v. U.S.*, 677 F.2d 72 (Ct.Cl. 1982), *Bank of America National Trust and Savings Association v. Commissioner,* 61 T.C. 752 (1974). The regulations set forth three tests for determining if a foreign tax is likely to reach net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

Paragraph (b)(2) of §1.901-2 states that the realization test is met if the predominant character of the foreign tax is that of a tax imposed on income at the time or after the time income would be realized under the Internal Revenue Code. The test can also be satisfied even if the tax is imposed prior to a realization event if the tax recaptures a tax deduction, tax credit or other allowance previously accorded the taxpayer. In addition, the test can be satisfied if the foreign tax is imposed on the appreciation in value of property or on the value of certain inventory property at the time of transfer, processing, or export, but only if such amounts are not subject to foreign tax at a later time, or, if they are subject to tax, a credit is given for the earlier tax. Certain foreign taxes imposed on the deemed distribution of profits also satisfy the realization test.

Several changes were made to the realization test of the proposed regulations in response to comments made by the public. The test was expanded to cover a tax on the appreciation of any type of property and not just stock, securities, and readily marketable securities. In addition, it was clarified that the imposition of a second tax does not disqualify a tax on a prerealization event if a credit is given for the first tax. The proposed regulations had a rule pertaining to certain distributions and deemed distributions. The rule has been rewritten to apply only to deemed distributions since a tax clearly meets the realization test if it is imposed on an actual distribution of amounts that meet the realization test.

The gross receipts test set forth in pararaph (b)(3) of §1.901-2 is satisfied if the predominant character of the foreign tax is that of a tax imposed on the basis of gross receipts. The regulations also allow a tax imposed on a base of estimated gross receipts if the method used is likely to produce an amount that is not greater than fair market value. The proposed regulations would have allowed a tax imposed on estimated gross receipts only in the case of: (1) transactions with respect to which it is reasonable to believe that gross receipts may not otherwise be clearly reflected, or (2) certain prerealization events. In response to comments made by the public, these restrictions have been deleted.

The third test of the regulations is whether the predominant character of the foreign tax is that of a tax on net income. Paragraph (b)(4) of §1.901-2 states that a tax imposed on a base of gross receipts reduced by significant costs and expenses (including capital expenditures) attributable to that income is a tax on net income. Certain formularly methods of computing taxable income satisfy this test. In rare cases where income is of a type (such as wages) that generally does not have significant related expenses, a foreign tax may be considered to be imposed on net income even if no deductions are allowed.

The net income test has been clarified in several respects in response to comments received. A sentence has been added at the end of paragraph (b)(4)(i) specifically stating that a tax need not give a deduction for another tax that meets the realization, gross receipts, and net income requirements. In addition, the rules concerning the consolidation of profits and losses have been clarified by the insertion of examples of separate activities within a trade or business (separate contract areas in the case of oil and gas exploration). The regulations also make clear that oil and gas extraction constitutes a separate trade or business from oil and gas refining and processing. Some persons requested that example 24 of §4.901-2(e) of the temporary regulations be included in the final regulations. The example lists certain deductions that are not allowed by a foreign tax and concludes that the tax meets the net income test, notwithstanding the disallowance. It was decided not to include the example in the final regulations in order to avoid the possible implication that a tax that disallowed additional deductions would not meet the net income test. Such a tax may or may not meet the net income test, depending on the additional deductions that are disallowed.

Even though a foreign tax satisfies the three tests of realization, gross receipts, and net income, the predominant character of the tax is not that of an income tax in the U.S. sense to the extent the foreign tax liability is dependent on the availability of a credit against the taxpayer's liability to another country. This rule is contained in paragraphs (a)(3)(ii) and (c) of §1.901-2. Several comments recommended the regulations be revised to deny a credit only to the extent the foreign tax is dependent on the availability of a credit against U.S. tax liability. This recommendation was not followed.

Under the regulations, the tests for determining creditability are applied to each separate foreign levy. Paragraph (d) of §1.901-2 provides that a levy consists of separate levies if it is imposed on a base that differs in kind, and not merely in degree, for different classes of persons subject to the levy. Taxes imposed by different levels of a government are always separate levies. A tax imposed under foreign law as modified by a contract is a separate tax imposed on those persons subject to the contractual modification. Special rules with respect to levies imposed on dual capacity taxpayers are found in §1.901-2A(a).

Amounts of foreign income, war profits, or excess profits taxes that are creditable must be paid or accrued to the foreign country by or on behalf of the taxpayer. Paragraph (e) of §1.901-2 contains rules with respect to the amount of a qualifying tax that is creditable, subject to limitations such as those contained in section 904. Amounts of tax paid or accrued to a foreign country do not include amounts that are: (1) reasonably certain to be refunded, credited, rebated, abated, or forgiven, (2) used directly or indirectly as a subsidy to the taxpayer, or (3) not compulsory payments. To the extent a taxpayer does not make reasonable efforts to minimize its foreign tax liability over time, the payment is not compulsory and is therefore not an amount of tax paid. A taxpayer is not required to change the form of a transaction in order to minimize its foreign tax liability.

The proposed regulations provided that an amount was not paid or accrued if it was reasonably likely to be refunded, credited, rebated, abated, or forgiven. Following the recommendation of certain comments, these final regulations substitute the word "certain" for "likely". Also in response to certain comments, the regulations give further guidance as to how far a taxpayer has to go to reduce his tax liability.

Paragraph (e) of §1.901-2 also provides rules with respect to multiple levies. If the initial amount of one foreign liability is reduced by the amount of another levy, the amount of the first liability that is paid or accrued is the excess of the initial liability over the other levy. This is the rule of *Helvering v. Queen Insurance Co.*, 115 F. 2d 341 (2d Cir. 1940), *cert. den.* 312 U.S. 706 (1941). The amount of the other levy that is paid or accrued is not reduced due to its use as an offset. If the taxpayer's liability is the greater or lesser of two amounts, the taxpayer is considered to pay or accrue only the levy for which he is liable for that period. Thus, if the taxpayer is liable for the greater of an income tax or an excise tax and for one period the income tax liability is larger, the taxpayer is considered to be liable only for the income tax, and not for the excise tax, for that period.

Various comments criticized the results of the two situations described above. If a person pays the greater of an income tax and an excise tax, he gets a full credit if the income tax is greater. However, if the person had been given a credit against his income tax for the amount of the excise tax, he would only get a credit for the difference between the income tax and the excise tax. It was suggested that in the latter situation the excise tax should be creditable as an in-lieu-of tax. It was decided to retain the rules of the proposed regulations, which respect foreign law in determining which levy or levies are paid.

The rules of the temporary regulations involving advance corporation taxes (§4.901-2(f)(4)(iv)) have been deleted because they apply to only one type of integrated tax system. The final regulations reserve a paragraph to contain more general rules for the treatment of taxes under integrated tax systems.

The final regulations also do not contain the rule of the temporary regulations regarding the accrual of contested foreign taxes (§4.901-2(f)(6)). No reason could be found for giving a credit when a person is contesting a tax and has not yet paid it. Thus, Revenue Rulings 58-55, 1958-1 C.B. 266; 70-290, 1970-1 C.B. 160; and 77-487, 1977-2 C.B. 479, again state the position of the Internal Revenue Service on this issue. It is anticipated that in the near future another Revenue Ruling will be issued, consolidating and expanding on the credit rulings.

Paragraph (f) of §1.901-2 contains the general rule that a foreign income tax can be paid or accrued only by or on behalf of a taxpayer who is liable for the amount under foreign law. The final regulations, however, include an exception not found in the proposed regulations. A recipient of wages will be considered to be subject to legal liability for pension, unemployment, disability fund, and other similar payments if such amounts are deducted from the wages under provisions comparable to section 3102(a) and (b) of the Internal Revenue Code. Paragraph (f) also contains specific rules with respect to: (1) a contractual agreement under which the income tax liability of the taxpayer is paid by another person, and (2) joint and several liability for income tax.

Paragraph (g) of §1.901-2 contains definitions of the term "paid," "foreign country," and "foreign levy" for purposes of §§1.901-2, 1.901-2A, and 1.903-1.

Paragraph (h) contains the effective date provision for §§1.901-2, 1.901-2A, and 1.903-1. Generally, the regulations are effective for taxable years beginning after [date that is 30 days after date of publication of these regulations in the FEDERAL REGISTER]. However, taxpayers may elect to have the regulations apply to any open taxable year on a country-by-country basis. If the election is made with respect to one country, it applies to all levies imposed by the country and any of its political subdivisions for the year for which the election is made and all subsequent years. The election cannot be revoked.

§1.901-2A

Under §1.901-2(a)(2)(i), a payment to a foreign government in exchange for a specific economic benefit is not a tax. A taxpayer who receives a specific economic benefit ("dual capacity taxpayer") must establish the portion (if any) of his payment to the foreign government that is tax. Rules pertaining to this burden are contained in §1.901-2A.

Under paragraph (a)(1) of §1.901-2A, no portion of a payment by a dual capacity taxpayer is considered to be compensation for a specific economic benefit if the payment is pursuant to a levy that is imposed on both dual capacity taxpayers and other taxpayers. A levy imposed on dual capacity taxpayers is also imposed on other taxpayers only if the levy is applied, by its terms and in practice, in the same manner to other taxpayers as to dual capacity taxpayers.

Paragraph (b)(2) of §1.901-2A confirms that a dual capacity taxpayer entitled to the benefits of a tax treaty to which the United States is a party and which provides for the creditability of a foreign tax for U.S. tax purposes, may choose the benefits of the treaty, subject to any terms, conditions, and limitations contained in the treaty.

Paragraph (c) sets forth the two methods available to a dual capacity taxpayer if the taxpayer is not subject to the same levy as other taxpayers and is not claiming a credit under a treaty. The first method is to establish by all of the relevant facts and circumstances, the portion, if any, of the levy that is not paid in exchange for a specific economic benefit. Neither the methodology of the elective safe harbor method described below nor the results that would have obtained if the safe harbor method had been elected may be taken into account as relevant facts or circumstances under this method.

The second method, the elective safe harbor method, is described in paragraph (c)(3) of §1.901-2A. A dual capacity taxpayer may elect to use this method in accordance with paragraph (d) on a country-by-country basis. A taxpayer who elects the safe harbor method applies the formula set forth in paragraph (e). The formula is intended to provide a credit under section 901 or 903 for an amount approximating the amount of generally imposed income tax that would have been paid if the taxpayer had not been a dual capacity taxpayer and if the amount considered to be paid for the specific economic benefit had been deductible in determining the foreign income tax liability. However, if a country that imposes a levy based on realized net income on a dual capacity taxpayer does not have a generally imposed income tax, the dual capacity taxpayer may use the lower of the rate specified in section 11(b)(5) of the Internal Revenue Code or the rate of the foreign levy in applying the safe harbor formula.

An election to use the safe harbor method for a country is effective for the taxable year for which it is made and all subsequent years unless revoked with the consent of the Commissioner of Internal Revenue. The making of a safe harbor election constitutes a waiver of the right to use the facts and circumstances method with respect to any levy imposed by countries covered by the election.

If a payment by a dual capacity taxpayer to the foreign country is determined to have two elements – an amount that is income tax or tax in lieu of income tax and an amount that is paid in exchange for a specific economic benefit – the amount paid in exchange for the specific economic benefit is characterized (as royalty, purchase price, etc.) according to the nature of the transaction. Such characterization applies for all purposes of Chapter 1 of the Code, except that any determination by reason of the safe harbor method that an amount is not tax shall not be taken into account in determining whether or not such amount is to be characterized and treated as tax for purposes of computing an allowance for percentage depletion under sections 611 and 613.

The proposed regulations allow a safe harbor election to be made retroactively only with respect to taxable years beginning before the general effective date of the regulations. The final regulations also allow a retroactive election if: (1) a person reasonably believed that he was not a dual capacity taxpayer or was not subject to a qualifying levy and the Commissioner consents to the retroactive election, or (2) a person originally deducted taxes for the taxable year with respect to which he now wishes to make the election. The final regulations also provide the following additional situations in which the Commissioner will normally consent to a revocation of a safe harbor election: (1) the Internal Revenue Service has issued a letter ruling to the electing person which adversely affects the person's application of the safe harbor method, and (2) a corporation that is a dual capacity taxpayer becomes a member of an affiliated group that already contains a member that is a dual capacity taxpayer with respect to the same country, and immediately prior thereto one of such dual capacity taxpayers had a safe harbor election in effect with respect to the country and the other did not.

Under the proposed regulations, a provision of the general tax (*e.g.*, treatment of an income item, a deduction, or a rate) cannot be applied in using the safe harbor method if the provision does not apply in practice to persons other than dual capacity taxpayers. A number of comments indicated that in many cases it would be extremely burdensome for a dual capacity taxpayer to establish that a provision applies in practice to non-dual capacity taxpayers. Paragraph (e)(4)(ii) of the final regulations states that a provision (including tax rate) that by its terms applies to persons other than dual capacity taxpayers will generally be assumed to be reasonably likely to apply in practice to such other persons unless the person claiming credit knows or has reason to know otherwise.

Many comments criticized the proposed regulations for not allowing a credit under the safe harbor method if the foreign country does not have a general tax. They suggested that either the facts and circumstances method explicitly deal with this situation or the safe harbor method be modified so that the tax rate of a neighboring country or of the U.S. could be applied. The final regulations provide that if a country that does not have a general tax imposes a levy based on realized net income on a dual capacity taxpayer, the safe harbor formula may be applied using the lower of the rate of that levy or the rate specified in section 11(b)(5) of the Internal Revenue Code (currently 46%).

§1.903-1

Section 903 provides that the credit granted by section 901 shall also be available for a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by a foreign country or U.S. possession. The regulations under section 903 describe these taxes. The rules under section 901 for determining the amount of tax paid or accrued by or on behalf of a taxpayer also apply to section 903 taxes.

To qualify as a tax in lieu of a tax on income, war profits, or excess profits, a levy must satisfy the definition of a tax in §1.901-2(a)(2). The tax must also be in substitution for, and not in addition to, a generally imposed income tax. To the extent that the amount of the foreign tax liability is contingent upon the availability of a credit against the amount of income tax owed to another country, a tax is not in substitution for an otherwise generally imposed income tax. The comparability requirement in temporary regulation §4.903-1(c) is not contained in these final regulations.

Creditability under §1.903-1 is not dependent on administrative difficulty in applying the generally imposed income tax. The base of the tax need not bear any relation to realized net income; a section 903 tax may be imposed on gross receipts, gross income, or a base that bears no resemblance to income. A taxpayer may be entitled to credit under section 903 for a tax with respect to certain of its activities, even though the taxpayer is also subject to a generally imposed income tax on its income from other activities. As under section 901, each separate levy is evaluated in its entirety for all persons subject to the tax, and the rules of §1.901-2A apply to dual capacity taxpayers.

[. . .]

§1.901-2 Income, war profits, or excess profits tax paid or accrued

(a) *Definition of income, war profits, or excess profits tax.* – (1) *In general.* Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as "income tax" for purposes of this section and §§1.901-2A and 1.903-1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if –
(i) It is a tax; and
(ii) The predominant character of that tax is that of an income tax in the U.S. sense.
Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms "paid by," "foreign country," and "foreign levy".
Paragraph (h) of this section states the effective date of this section.

(2) *Tax.*–(i) *In general.* A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: a tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and §1.901-2A.

(ii) *Dual capacity taxpayers.* – (A) *In general.* For purposes of this section and §§1.901-2A and 1.903-1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a "dual capacity taxpayer." Dual capacity taxpayers are subject to the special rules of §1.901-2A.

(B) *Specific economic benefit.* For purposes of this section and §§1.901-2A and 1.903-1, the term "specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(C) *Pension, unemployment, and disability fund payments.* A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) *Control of property.* A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) *Indirect receipt of a benefit.* A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person–
(1) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or
(2) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) *Predominant character.* The predominant character of a foreign tax is that of an income in the U.S. sense–
(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,
(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) *Net gain.* – (1) *In general.* A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) *Realization.* – (i) *In general.* A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed –

(A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and –
(1) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or
(2) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).
A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(ii) *Certain deemed distributions.* A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (*e.g.*, by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (*e.g.*, an actual distribution), impose tax ("second tax") with respect to the income on which tax was imposed by reason of such deemed distribution (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid with respect to the deemed distribution).

(iii) *Readily marketable property.* Property is readily marketable if –
(A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, and
(B) It can be sold on the open market without further processing or it is exported from the foreign country.

[. . .]

(3) *Gross receipts.* – (i) *In general.* A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of –
(A) Gross receipts; or
(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.
A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(ii) *Examples.* The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example (1). Country X imposes a headquarters company tax on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example (2). The facts are the same as in Example (1), with the added fact that in the case of a particular taxpayer, A, the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a)(1) of this section, the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax.
Accordingly, the result is the same as in example (1) for all persons subject to the headquarters company tax, including A.

Example (3). Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not satisfy the gross receipts requirement. However, if the tax satisfies the criteria of §1.903-1(a), it is a tax in lieu of an income tax.

(4) Net income. – (i) *In general.* A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit –

(A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or
(B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for non-recovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (*e.g.*, principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) *Consolidation of profits and losses.* In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity, (*e.g.*, a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (*e.g.*, a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether a person's profits and losses from one trade or business (*e.g.*, oil and gas extraction) are allowed to offset its profits and losses from another trade or business (*e.g.*, oil and gas refining and processing), or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) *Carryovers.* In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

[. . .]

(c) *Soak-up taxes.* – (1) *In general.* Pursuant to paragraph (a)(3)(ii) of this section, the predominant character of a foreign tax that satisfies the requirement of paragraph (a)(3)(i) of this section is that of an income tax in the U.S. sense only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit.

[. . .]

(d) *Separate levies.* – (1) *In general.* For purposes of sections 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. A levy imposed by one taxing authority (*e.g.*, the national government of a foreign country) is always separate for purposes of sections 901 and 903 from a levy imposed by another taxing authority (*e.g.*, a political subdivision of that foreign country). Levies are not separate merely because different rates apply to different taxpayers. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding the levy has graduated rates and applies different rate schedules to unmarried individuals, married individuals who file separate returns and married individuals who file joint returns. In general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (*e.g.*, section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B) and 465(a)(1)(C), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (*e.g.*, section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)). However, where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered for purposes of sections 901 and 903 to impose separate levies for such classes of persons. For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code as it applies to persons other than those described in section 871(b), and foreign levies identical to the taxes imposed by sections 11, 541, 881, 1491 and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph §1.903-1. Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of sections 901 and 903, to be imposed. A separate base may consist, for example, of a particular type of income or of an amount unrelated to income, *e.g.*, wages paid. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. In the case of levies that apply to dual capacity taxpayers, see also §1.901-2A(a).

(2) *Contractual modifications.* Notwithstanding paragraph (d)(1) of this section, if foreign law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then foreign law is considered for purposes of sections 901 and 903 to impose a separate levy for all persons to whom such contractual modification of the levy applies, as contrasted to the levy as ap-

plied to all persons to whom such contractual modification does not apply. In applying the provisions of paragraph (c) of this section to a tax as modified by such a contract, the provisions of §1.903-1(b)(2) shall apply.

[. . .]

(e) *Amount of income tax that is creditable.* – (1) *In general.* Credit is allowed under section 901 for the amount of income tax (within the meaning of paragraph (a)(1) of this section) that is paid to a foreign country by the taxpayer. The amount of income tax paid by the taxpayer is determined separately for each taxpayer.

(2) *Refunds and credits.* – (i) *In general.* An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

[. . .]

(3) *Subsidies.* – (i) *General rule.* An amount is not an amount of income tax paid by a taxpayer to a foreign country to the extent that –
(A) The amount is used, directly or indirectly, by the country to provide a subsidy by any means (such as through a refund or credit) to the taxpayer; and
(B) The subsidy is determined, directly or indirectly, by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the taxpayer.

(ii) *Indirect subsidies.* A foreign country is considered to provide a subsidy to a taxpayer if the country provides a subsidy to another person that –
(A) Owns or controls, directly or indirectly, the taxpayer or is owned or controlled, directly or indirectly, by the taxpayer or by the same persons that own or control, directly or indirectly, the taxpayer, or
(B) Engages in a transaction with the taxpayer, but only if the subsidy received by such other person is determined, directly or indirectly, by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the taxpayer with respect to such transaction.

(iii) *Example.* The provisions of this paragraph (e)(3) may be illustrated by the following example:

Example. Country X imposes a 30-percent tax on interest received by nonresident lenders from borrowers who are residents of country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders. Because the incentive payment is based on such interest, it is determined by reference to the base used to compute the tax in lieu of an income tax that is imposed on the nonresident lender. Under paragraph (e)(3)(ii)(B) of this section, the incentive payment is considered a subsidy provided indirectly to the nonresident lender since it is provided to a person (the borrower) that engaged in a business transaction with the lender and is based on the amount of tax in lieu of an income tax that is imposed on the lender with respect to this transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by a resident borrower from interest payments to a nonresident lender is not tax in lieu of an income tax that is paid by the lender under paragraph (e)(3)(i) of this section and §1.903-1(a).

(4) *Multiple levies.* – (1) *In general.* If, under foreign law, a taxpayer's tentative liability for one levy (the "first levy") is or can be reduced by the amount of the taxpayer's liability for a different levy (the "second levy"), then the amount considered paid by the taxpayer to the foreign country pursuant to the second levy is an amount equal to its entire liability for that levy, and the remainder of the amount paid is considered paid pursuant to the first levy. This rule applies regardless of whether it is or is not likely that liability for one such levy will always exceed liability for the other such levy. For an example of the application of this rule, see example (5) of § 1.903-1(b)(3). If under foreign law, the amount of a taxpayer's liability is the greater or lesser of amounts computed pursuant to two levies, then the entire amount paid to the foreign country by the taxpayer is considered paid pursuant to the levy that imposes such greater or lesser amount, respectively, and no amount is considered paid pursuant to such other levy.

(ii) *Integrated tax systems.* [Reserved]

(5) *Noncompulsory amounts.* – (i) *In general.* An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where a foreign tax includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or in part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (*e.g.*, a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.

[. . .]

(f) Taxpayer. – (1) *In general.* The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax. For purposes of this section, §1.901-2A and §1.903-1, the person on whom foreign law imposes such liability is referred to as the "taxpayer". "A foreign tax of a type described in paragraph (a)(2)(ii)(C) of this section is considered to be imposed on the recipients of wages if such tax is deducted from such wages under provisions that are comparable to section 3102(a) and (b) of the Internal Revenue Code.

(2) *Party undertaking tax obligation as part of transaction.* – (i) *In general.* Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph (e)(3) of this section. See §1.901-2A for additional rules regarding dual capacity taxpayers.

[. . .]

(3) *Taxes paid on combined income.* If foreign income tax is imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of tax, regardless of which person actually pays the tax.

(g) *Definitions.* For purposes of this section and §§1.901-2A and 1.903-1, the following definitions apply:
(1) The term "paid" means "paid or accrued"; the term "payment" means "payment or accrual"; and the term "paid by" means "paid or accrued by or on behalf of."
(2) The term "foreign country" means any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States. The term "possession of the United States" includes Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa.

(3) The term "foreign levy" means a levy imposed by a foreign country.

(h) *Effective date.* – (1) *In general.* This section §1.901-2A, and §1.903-1 apply to taxable years beginning after [date that is 30 days after date of publication of these regulations 14 Nov 1983 in the Federal Register]. In addition, a person may elect to apply the provisions of this section, §1.901-2A, and §1.903-1 to earlier years. See paragraph (h)(2) of this section.

(2) *Election to apply regulations to earlier years.* – (i) *Scope of election.* An election to apply the provisions of this section, §1.901-2A, and §1.903-1 to taxable years beginning on or before [date that is 30 days after date of publication of these regulations 14 Nov 1983 in the Federal Register] is made with respect to one or more foreign states and possessions of the United States with respect to a taxable year of the person making the election beginning on or before [date that is 30 days after date of publication of these regulations 14 Nov 1983 in the Federal Register]. Such election requires all of the provisions of this section, §1.901-2A, and §1.903-1 to be applied to such taxable year and to all subsequent taxable years of the person making the election ("elected years"). If an election applies to a foreign state or to a possession of the United States ("election country"), it applies to all taxes of the election country and to all taxes of all political subdivisions of the election country. An election does not apply to foreign taxes carried forward to any elected year from any taxable year to which the election does not apply. Such election does apply to foreign taxes carried back or forward from any elected year to any taxable year.

(ii) *Effect of election.* An election to apply the regulations to earlier years has no effect on the limitations on assessment and collection or on the limitations on credit or refund (see Chapter 66 of the Internal Revenue Code).

(iii) *Manner of making election.* An election to apply the regulations to one or more earlier taxable years is made by attaching a statement to a return, amended return, or claim for refund for the earliest taxable year to which the election relates. Such statement shall state that the election is made and, unless the election is to apply to all foreign countries, the statement shall designate the election countries. In the absence of such a designation of the election countries, all foreign countries shall be election countries.

(iv) *Time for making election.* An election to apply the regulations to earlier taxable years must be made by [date that is 1 year after date of publication of these regulations in the Federal Register] except that if a person who has deducted (instead of credited) foreign taxes in its United States income tax return for such an earlier taxable year validly makes an election to credit (instead of deduct) such taxes in a timely filed amended return for such an earlier taxable year validly makes an election to credit (instead of deduct) such taxes in a timely filed amended return for such earlier taxable year and such amended return is filed after such date, an election to apply the regulations to such earlier taxable year must be made in such amended return.

(v) *Revocation of election.* An election to apply the regulations to earlier taxable years may not be revoked.

(vi) *Affiliated groups.* A member of an affiliated group that files a consolidated United States income tax return may apply the regulations to earlier years only if an election to so apply them has been by the common parent of such affiliated group on behalf of all members of the group.

Approved by the Office of Management and Budget under control number 1545-0746,

Par. 2. A new §1.901-2A is added immediately after §1.901-2 to read as follows:

§1.901-2A Dual capacity taxpayers

(a) *Application of separate levy rules as applied to dual capacity taxpayers.* – (1) *In general.* If the application of a foreign levy (as defined in §1.901-2(g)(3)) is different, either by the terms of the levy or in practice, for dual capacity taxpayers (as defined in §1.901-2(a)(2)(ii)(A)) from its application to other persons, then unless the only such difference is that a lower rate (but the same base) applies to dual capacity taxpayers, such difference is considered to be related to the fact that dual capacity taxpayers receive, directly or indirectly, a specific economic benefit (as defined in §1.901-2(a)(2)(ii)(B)) from the foreign country and thus to be a difference in kind, and not merely of degree. In such a case, notwithstanding any contrary provision of §1.901-2(d), the levy as applicable to such dual capacity taxpayers is a separate levy (within the meaning of §1.901-2(d)) from the levy as applicable to such other persons, regardless of whether such difference is in the base of the levy, in the rate of the levy, or both. In such a case, each of the levy as applied to dual capacity taxpayers and the levy as applied to other persons must be analyzed separately to determine whether it is an income tax within the meaning of §1.901-2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of §1.903-1(a). However, if the application of the levy is neither different by its terms nor different in practice for dual capacity taxpayers from its application to other persons, or if the only difference is that a lower rate (but the same base) applies to dual capacity taxpayers, then, in accordance with §1.901-2(d), such foreign levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy. In such a case, no amount paid (as defined in §1.901-2(g)(1) pursuant to such levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and such levy, as applicable in the aggregate to such dual capacity taxpayers and to such other persons, is analyzed to determine whether it is an income tax within the meaning of §1.901-(a)(1) or a tax in lieu of an income tax within the meaning of §1.903-1(a). Application of a foreign levy to dual capacity taxpayers will be considered to be different in practice from application of that levy to other persons, even if no such difference is apparent from the terms of the levy, unless it is established that application of that levy to dual capacity taxpayers does not differ in practice from its application to other persons.

[. . .]

(b) *Burden of proof for dual capacity taxpayers.* – (1) *In general.* For credit to be allowable under section 901 or 903, the person claiming credit must establish that the foreign levy with respect to which credit is claimed is an income tax within the meaning of §1.901-2(a)(1) or a tax in lieu of an income tax within the meaning of §1.903-1(a), respectively. Thus, such person must establish, among other things, that such levy is a tax. See §1.901-2(a)(2)(i) and §1.903-1(a). Where a person claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to foreign levy, §1.901-2(a)(2)(i) and §1.903-1(a), respectively, require such person to establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax. If, pursuant to paragraph (a)(1) of this section and §1.901-2(d), such levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy, then no amount paid pursuant to that levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit. Accordingly, such levy has only one distinct element, and the levy either is or is not, in its entirety, a tax. If, however, such levy as applicable to dual capacity taxpayers is a separate levy from such levy as applicable to other persons, then a person claiming credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to such separate levy may establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax only by the facts and circumstances method or the safe harbor method described in paragraph (c) of this section. If such person fails to so establish such amount, no portion of the amount that is paid pursuant to the separate levy by the dual capacity taxpayer to such foreign country shall be treated as an amount of tax. Any amount that, either by reason of application of the methods of paragraph (c) of this section or by reason of the immediately preceding sentence, is not treated as an amount of tax shall (i) be considered to have been paid in exchange for a specific economic benefit; (ii) be characterized (e.g., as royalty, purchase price, cost of sales, reduction of the proceeds of a sale, or reduction of interest income) according to the nature of the transaction and of the specific economic benefit received; and (iii) be treated according to such characterization for all purposes of Chapter 1 of the Internal Revenue Code, except that any determination that an amount is not tax for purposes of section 901 or 903 by reason of application of the safe harbor method shall not be taken into account in determining whether or not such an amount is to be characterized and treated as tax for purposes of computing an allowance for percentage depletion under sections 611 and 613.

(2) *Effect of certain treaties.* If, irrespective of whether such credit would be allowable under section 901 or 903 in the absence of a treaty, the United States has in force a treaty with a foreign country that treats a foreign levy as an income tax for purposes of allowing credit for United States tax and if the person claiming credit is entitled to the benefit of such treaty, then, unless such person claims credit not under the treaty but under section 901 and 903, and except to the extent the treaty provides otherwise and subject to all terms, conditions and limitations provided in the treaty, no portion of an amount paid with respect to such levy by a dual capacity taxpayer shall be considered to be paid in exchange for a specific economic benefit. If, however, such person claims credit not under such treaty but rather under section 901 or 903 (e.g., so as not to be subject to a limitation contained in such treaty), the provisions of the section apply to such levy.

(c) *Satisfaction of burden of proof.* – (1) *In general.* This paragraph (c) sets out the methods by which a person who claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to a foreign levy that satisfies all of the criteria of sections 901 and 903 other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to the distinct element (a "qualifying levy") may establish such distinct element and amount. Such person must establish the amount paid pursuant to a qualifying levy that is paid pursuant to the distinct element of the levy that is a tax (which amount therefore is an amount of income tax within the meaning of §1.901-2(a)(1) or an amount of tax in lieu of income tax within the meaning of §1.903-1(a) (a "qualifying amount") only by the facts and circumstances method set forth in paragraph (c)(2) of this section or the safe harbor method set forth in paragraph (c)(3) of this section. A levy is not a qualifying levy, and neither the facts and circumstances method nor the safe harbor method applies to an amount paid by a dual capacity taxpayer pursuant to a foreign levy, if it has been established pursuant to §1.901-2(d) any paragraph (a)(1) of this section that the levy as applied to that dual capacity taxpayer and that levy as applied to persons other than dual capacity taxpayers together constitute a single levy, or if it has been established in accordance with the first sentence of paragraph (b)(2) of this section that credit is allowable by reason of a treaty for an amount paid with respect to such levy.

(2) *Facts and circumstances method.* – (i) *In general.* If the person claiming credit establishes, based on all of the relevant facts and circumstances, the amount, if any, paid by the dual capacity taxpayer pursuant to the qualifying levy is not paid in exchange for a specific economic benefit, such amount is the qualifying amount with respect to such qualifying levy. In determining the qualifying amount with respect to a qualifying levy under the facts and circumstances method, neither the methodology nor the results that would have obtained if a person had elected to apply the safe harbor method to such qualifying levy is a relevant fact or circumstance. Accordingly, neither such methodology nor such results shall be taken into account in applying the facts and circumstances method.

(3) *Safe harbor method.* Under the safe harbor method, the person claiming credit makes an election as provided in paragraph (d) of this section and, pursuant to such election, applies the safe harbor formula described in paragraph (e) of this section to the qualifying levy or levies to which the election applies.

(d) *Election to use the safe harbor method.* – (1) *Scope of election.* An election to use the safe harbor method is made with respect to one or more foreign states and possessions of the United States with respect to a taxable year of the person making the election (the "electing person"). Such election applies to such taxable year and to all subsequent taxable years of the electing person ("election years"), unless the election is revoked in accordance with paragraph (d)(4) of this section. If an election applies to a foreign state or possession of the United States ("elected country"), it applies to all qualifying levies of the elected country and to all qualifying levies of the elected country and to all qualifying levies of all political subdivisions of the elected country with respect to which the electing person claims credit for amounts paid (or deemed to be paid) by any dual capacity taxpayer. A member of an affiliated group that files a consolidated United States income tax return may use the safe harbor method for a foreign state or U.S. possession only if an election to use the safe harbor method for that state or possession has been made by the common parent of such affilited group on behalf of all members of the group. Similarly, a member of an affiliated group that does not file a consolidated United States income tax return may elect to use the safe harbor method for a foreign state or a U.S. possession only if an election to use the safe harbor method for that state or possession is made by each member of the affiliated group which claims credit for taxes paid to such state or possession or to any political subdivision thereof. An election to use the safe harbor method for an elected country does not apply to foreign taxes carried back or forward to any election year from any taxable year to which the election does not apply. Such election does apply to foreign taxes carried back or forward from any election year to any taxable year. A person who elects to use the safe harbor method for one or more foreign countries may, in a later taxable year, also elect to use that method for other foreign countries.

(2) *Effect of election.* An election to use the safe harbor method described in paragraph (c)(3) of this section requires the electing person to apply the safe harbor formula of paragraph (e) of this section to all qualifying levies of all elected countries and their political subdivisions, and constitutes a specific waiver by such person of the right to use the facts and circumstances method described in paragraph (c)(2) of this section with respect to any levy of any elected country or any political subdivision thereof.

(3) *Time and manner of making election.* – (i) *In general.* To elect to use the safe harbor method, an electing person must attach a statement to its United States income tax return for the taxable year for which the election is made and must file such return by the due date (including extensions) for the filing thereof. Such statement shall state that the electing person elects to use the safe harbor method for the foreign states and the possessions of the United States designated in the statement and their political subdivisions, and that the electing person waives the right, for any election year, to use the facts and circumstances method for any levy of the designated states, possessions and political subdivisions. Notwithstanding the foregoing, a person may, with the consent of the Commissioner, elect to use the safe harbor method for a taxable year for one or more foreign states or possessions of the United States, at a date later than that specified in the first sentence of this paragraph (d)(3)(i), e.g., upon audit of such person's United States income tax return for such taxable year. The Commissioner will normally consent to such a later election if such person demonstrates that it failed to make a timely election for such a foreign state or possession for such taxable year because such person reasonably believed either that it was not a dual capacity taxpayer with respect to such state or possession or that no levy that it paid to such state or possession or any political subdivision thereof was a qualifying levy (for example, because it reasonably, but incorrectly, believed that the levy it paid was not a separate levy from that applicable to persons other than dual capacity taxpayers). The Commissioner will not, however, consent to such a later election with respect to any state or possession for a taxable year if such person (or any other member of an affiliated group of which such person is a member) applied the facts and circumstances method to any levy of such state or possession or any political subdivision thereof for such taxable year.

(ii) *Retroactive election.* Notwithstanding the requirements of paragraph (d)(3)(i) of this section relating to the time and manner of making an election, an election may be made for a taxable year beginning on or before [date that is 30 days after date of publication of these regulations in the Federal Register], provided the electing person elects in accordance with §1.901-2(h) to apply all of the provisions of this section, §1.901-2 and §1.903-1 to such taxable year and provided all of the requirements set forth in this paragraph (d)(3)(ii) are satisfied. Such an election shall be made by timely (including extensions) filing a federal income tax return or any amended federal income tax return for such taxable year; by attaching to such return a statement containing the statements and information set forth in paragraph (d)(3)(i) of this section; and by filing amended income tax returns for all subsequent election years for which income tax returns have previously been filed in which credit is claimed under section 901 or 903 and applying the safe harbor method in such amended returns. All amended returns referred to in the immediately preceding sentence must be filed on or before [date that is 1 year after date of publication of these regulations in the Federal Register] (unless the Commissioner consents to a later filing in circumstances similar to those provided in paragraph (d)(3)(i)) and at a time when neither assessment of a defiency for any of such election years nor the filing of a claim for any refund claimed in any such amended return is barred.

(iii) *Election to credit taxes made in amended return.* If a person has filed a United States income tax return for a taxable year to which this §1.901-2A applies (including application by reason of the election provided in §1.901-2(h)(2)) in which such person has deducted (instead of credited) qualifying foreign taxes and such person validly makes an election to credit (instead of deduct) such taxes in a timely amended return for such taxable year, an election to sue the safe harbor method may be made in such amended return provided all of the requirements of paragraph (d)(3)(ii) of this section are satisfied other than the requirement that such amended return and the other amended returns referred to in that paragraph be filed on or before [date that is 1 year after date of publication of these regulations in the Federal Register].

(4) *Revocation of election.* An election to use the safe harbor method described in paragraph (c)(3) of this section may not be revoked without the consent of the Commissioner. An application for consent to revoke such election with respect to one or more elected countries shall be made to the Commissioner of Internal Revenue, Washington, D.C. 20224. Such application shall be made not later than the 30th day before the due date

(including extensions) for the filing of the income tax return for the first taxable year for which the revocation is sought to be effective, except in the case of an event described in (i), (ii), (iii) or (iv) below, in which case an application for revocation with retroactive effect may be made within a reasonable time after such event. The Commissioner may make his consent to any revocation conditioned upon adjustments being made in one or more taxable years so as to prevent the revocation from resulting in a distortion of the amount of any item relating to tax liability in any taxable year. The Commissioner will normally consent to a revocation (including, in the case of (i), (ii), (iii) or (iv) below, one with retroactive effect), if

(i) An amendment to the Internal Revenue Code or the regulations thereunder is made which applies to the taxable year for which the revocation is to be effective and the amendment substantially affects the taxation of income from sources outside the United States under subchapter N of Chapter 1 of the Internal Revenue Code; or

(ii) After a safe harbor election is made with respect to a foreign state, a tax treaty between the United States and that state enters into force; that treaty applies to the taxable years for which the revocation is to be effective; or

(iii) After a safe harbor election is made with respect to a foreign state or possession of the United States, a material change is made in the tax law of that state or possession or of a political subdivision of that state or possession; and the changed law applies to the taxable year for which the revocation is to be effective and has a material effect on the taxpayer; or

(iv) With respect to a foreign country to which a safe harbor election applies, the Internal Revenue Service issues a letter ruling to the electing person and that letter ruling (A) relates to the availability or application of the safe harbor method to one or more levies of such foreign country; (B) does not relate to the facts and circumstances method described in paragraph (c)(2) of this section; and (C) fails to include a ruling requested by the electing person or includes a ruling contrary to one requested by such person (in either case, other than one relating to the facts and circumstances method) and such failure or inclusion has a material adverse effect on the amount of such electing person's credit for taxes paid to such foreign country for the taxable year for which the revocation is to be effective; or

(v) A corporation ("new member") becomes a member of an affiliated group; the new member and one or more pre-existing members of such group are dual capacity taxpayers with respect to the same foreign country; and, with respect to such country, whether the new member or pre-existing members (but not both) have made a safe harbor election; and the Commissioner in his discretion determines that obtaining the benefit of the right to revoke the safe harbor election with respect to such foreign country was not the principal purpose of the affiliation between such new member and such group; or

(vi) The election has been in effect with respect to at least three taxable years prior to the taxable year for which the revocation is to be effective. The Commissioner may, in his discretion, consent to a revocation even if none of the foregoing subdivisions (i) through (vi) is applicable. If an election has been revoked with respect to an elected country, a subsequent election to apply the safe harbor method with respect to such elected country may be made only with the consent of the Commissioner and upon such terms and conditions as the Commissioner in his discretion may require.

(e) *Safe harbor formula.* – (1) *In general.* The safe harbor formula applies to determine the distinct element of a qualifying levy that is a tax and the amount paid by a dual capacity taxpayer pursuant to such qualifying levy that is the qualifying amount with respect to such levy. Under the safe harbor formula the amount paid in a taxable year pursuant to a qualifying levy that is the qualifying amount with respect to such levy is an amount equal to:

$(A-B-C) \times D/(1-D)$

where: (except as otherwise provided in paragraph (e)(5) of this section)

A = the amount of gross receipts as determined under paragraph (e)(2) of this section

B = the amount of costs and expenses as determined under paragraph (e)(2) of this section

C = the total amount paid in the taxable year by the dual capacity taxpayer pursuant to the qualifying levy (the "actual payment amount")

D = the tax rate as determined under paragraph (e)(3) of this section

In no case, however, shall the qualifying amount exceed the actual payment amount; and the qualifying amount is zero if the safe harbor formula yields a qualifying amount less than zero. The safe harbor formula is intended to yield a qualifying amount that is approximately equal to the amount of generally imposed income tax within the meaning of paragraphs (a) and (b)(1) of §1.903-1 ("general tax") of the foreign country that would have been required to be paid in the taxable year by the dual capacity taxpayer if it had not been a dual capacity taxpayer and if the base of the general tax had allowed a deduction in such year for the amount ("specific economic benefit amount") by which the actual payment amount exceeds the qualifying amount. See, however, paragraph (e)(5) of this section if an elected country has no general tax. The specific economic benefit amount is considered to be the portion of the actual payment amount that is paid pursuant to the distinct portion of the qualifying levy that imposes an obligation in exchange for a specific economic benefit. The specific economic benefit amount is therefore considered to be an amount paid by the dual capacity taxpayer in exchange for such specific economic benefit, which amount must be treated for purposes of Chapter 1 of the Internal Revenue Code as provided in paragraph (b)(1) of this section.

(2) *Determination of gross receipts and costs and expenses.* For purposes of the safe harbor formula, gross receipts and costs and expenses are, except as otherwise provided in this paragraph (e), the gross receipts and the deductions for costs and expenses, respectively, as determined under the foreign law applicable in computing the actual payment amount of the qualifying levy to which the safe harbor formula applies. However, except as otherwise provided in this paragraph (e), if provisions of the qualifying levy increase or decrease the liability imposed on dual capacity taxpayers compared to the general tax liability of persons other than dual capacity taxpayers by reason of the determination or treatment of gross receipts or costs or expenses, the provisions generally applicable in computing such other persons' tax base under the general tax shall apply to determine gross receipts and costs and expenses for purposes of computing the qualifying amount. If provisions of the qualifying levy relating to gross receipts meet the requirements of §1.901-2(b)(3)(i), such provisions shall apply to determine gross receipts for purposes of computing the qualifying amount. If neither the general tax nor the qualifying levy permits recovery of one or more costs or expenses, and by reason of the failure to permit such recovery the qualifying levy does not satisfy the net income requirement of §1.901-2(b)(4) (even though the general tax does satisfy that requirement), then such cost or expense shall be considered a cost or expense for purposes of computing the qualifying amount.

If the qualifying levy does not permit recovery of one or more significant costs or expenses, but provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, then, for purposes of computing the qualifying amount, costs and expenses shall not include the costs and expenses under the general tax whose nonrecovery under the qualifying levy is compensated for by such allowances but shall instead include such allowances. In determining costs and expenses for purposes of computing the qualifying amount with respect to a qualifying levy, the actual payment amount with respect to such levy shall not be considered a cost or expense. For purposes of this paragraph, the following differences in gross receipts and costs and expenses between the qualifying levy and the general tax shall not be considered to increase the liability imposed on dual capacity taxpayers compared to the general tax liability of persons other than dual capacity taxpayers, but only if the general tax would be an income tax within the meaning of §1.901-2(a)(1) if such different treatment under the qualifying levy had also applied under the general tax.

(i) Differences in the time of realization or recognition of one or more items of income or in the time when recovery of one or more costs and expenses is allowed (unless the period of recovery of such costs and expenses pursuant to the qualifying levy is such that it effectively is a denial of recovery of such costs and expenses, as described in §1.901-2(b)(4)(i); and

(ii) Differences in consolidation or carryover provisions of the types described in paragraphs (b)(4)(ii) and (b)(4)(iii) of §1.901-2.

(3) *Determination of tax rate.* The tax rate for purposes of the safe harbor formula is the tax rate (expressed as a decimal) that is applicable in computing tax liability under the general tax. If the rate of the general tax varies according to the amount of the base of that tax, the rate to be applied in computing the qualifying amount is the rate that applies under the general tax to a person whose base is, using the terminology of paragraph (e)(1) of this section, "A" minus "B" minus the specific economic benefit amount paid by the

dual capacity taxpayer pursuant to the quantifying levy, provided such rate applies in practice to persons other than dual capacity taxpayers, or, if such rate does not apply in practice, the next lowest rate of the general tax that does so apply in practice.

(4) *Determination of applicable provisions of general tax.* – (i) *In general.* If the general tax is a series of income taxes (e.g., on different types of income), or if the application of the general tax differs by its terms for different classes of persons subject to the general tax (e.g., for persons in different industries), then, except as otherwise provided in this paragraph (e), the qualifying amount shall be computed by reference to the income tax contained in such series of income taxes, or in the case of such different applications the application of the general tax, that by its terms and in practice imposes the highest tax burden on persons other than dual capacity taxpayers. Notwithstanding the preceding sentence, the general tax amount shall be computed by references to the application of the general tax to entities of the same type (as determined under the general tax) as the dual capacity taxpayer and to persons of the same resident or nonresident status (as determined under the general tax) as the dual capacity taxpayer; and, if the general tax treats business income differently from non-business (e.g., investment) income (as determined under the general tax), the dual capacity taxpayer's business and non-business income shall be treated as the general tax treats such income. If for example, the dual capacity taxpayer would, under the general tax, be treated as a resident (e.g., because the general tax treats an entity that is organized in the foreign country or managed or controlled there as a resident) and as a corporation (i.e., because the rules of the general tax treat an entity like the dual capacity taxpayer as a corporation), and if some of the dual capacity taxpayer's income would, under the general tax, be treated as business income and some as nonbusiness income, the dual capacity taxpayer and its income shall be so treated in computing the qualifying amount.

(ii) *Establishing that provisions apply in practice.* For purposes of the safe harbor formula a provision (including tax rate) shall be considered a provision of the general tax only if it is reasonably likely that that provision applies by its terms and in practice to persons other than dual capacity taxpayers. In general, it will be assumed that a provision (including tax rate) that by its terms applies to persons other than dual capacity taxpayers is reasonably likely to apply in practice to such other persons, unless the person claiming credit knows or has reason to know otherwise. However, in cases of doubt, the person claiming credit may be required to demonstrate that such provision is reasonably likely so to apply in practice.

(5) *No general tax.* If a foreign country does not impose a general tax (and thus a levy, in order to be a qualifying levy must satisfy all of the criteria of section 901 (because section 903 cannot apply), other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to that distinct element), paragraphs (e)(2), (3) and (4) of this section do not apply to a qualifying levy of such country, and the terms of the safe harbor formula set forth in paragraph (e)(1) of this section are defined with respect to such levy as follows:

A = the amount of gross receipts as determined under the qualifying levy;
B = the amount of deductions for costs and expenses as determined under the qualifying levy;
C = the actual payment amount; and
D = the lower of the rate of the qualifying levy, or the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid.

(6) *Certain taxes in lieu of an income tax.* To the extent a tax in lieu of an income tax (within the meaning of §1.903-1(a)) that applies in practice to persons other than dual capacity taxpayers would actually have been required to be paid in the taxable year by a dual capacity taxpayer if it had not been a dual capacity taxpayer (e.g., in substitution for the general tax with respect to a type of income, such as interest income, dividend income, royalty income, insurance income), such tax in lieu of an income tax shall be treated as if it were an application of the general tax for purposes of applying the safe harbor formula of this paragraph (e) to such dual taxpayer, and such formula shall be applied to yield a qualifying amount that is approximately equal to the general tax (so defined) that would have been required to be paid in the taxable year by such dual capacity taxpayer if the base of such general tax had allowed a deduction in such year for the specific economic benefit amount.

(7) *Multiple levies.* If, in any election year of an electing person, with respect to any elected country and all of its political subdivisions,
(i) Amounts are paid by a dual capacity taxpayer pursuant to more than one qualifying levy or pursuant to one or more levies that are qualifying levies and one or more levies that are not qualifying levies by reason of the last sentence of paragraph (c)(1) of this section but with respect to which credit is allowable, or
(ii) More than one general tax (including a tax treated as if it were an application of the general tax under paragraph (e)(6)) would have been required to be paid by a dual capacity taxpayer (or taxpayers) if it (or they) had not been a dual capacity taxpayer, (or taxpayers) or
(iii) Credit is claimed with respect to amounts paid by more than one dual capacity taxpayer,
the provisions of this paragraph (e) shall be applied such that the aggregate qualifying amount with respect to such qualifying levy or levies plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies shall be the aggregate amount that would have been required to be paid in the taxable year by such dual capacity taxpayer (or taxpayers) pursuant to such general tax or taxes if it (or they) had not been a dual capacity taxpayer (or taxpayers) and if the base of such general tax or taxes had allowed a deduction in such year for the aggregate specific economic benefit amount (except that, if paragraph (e)(5) applies to any levy of such elected country or any political subdivision thereof, the aggregate qualifying amount for qualifying levies of such elected country and all of its political subdivisions plus the aggregate amount paid with respect to levies referred to in paragraph (e)(7)(i) that are not qualifying levies shall not exceed the greater of the aggregate amount paid with respect to levies referred to in paragraph (e)(7)(i) that are not qualifying levies and the amount determined in accordance with paragraph (e)(5) where "D" is the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid). However, in no event shall such aggregate amount exceed the aggregate actual payment amount plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are nor qualifying levies, nor be less than the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies. In applying (e)(7)(ii) a person who is not subject to a levy but who is considered to receive a specific economic benefit by reason of §1.901-2(a)(ii)(E) shall be treated as a dual capacity taxpayer. See example (12) in paragraph (e)(8) of this section.

[. . .]

(f) *Effective date.* The effective date of this section is as provided in §1.901-2(h).

Approved by the Office Management and Budget under control number 1545-0746.

Par. 3. A new §1.903-1 is added immediately after §1.902-2 to read as follows:

§1.903-1 Taxes in lieu of income taxes

(a) *In general.* Section 903 provides that the term "income, war profits, and excess profit taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits ("income tax") otherwise generally imposed by any foreign country. For purposes of this section and §§1.901-2 and 1.901-2A, such a tax is referred to as a "tax in lieu of an income tax"; and the terms "paid" and "foreign country" are defined in §1.901-2(g). A foreign levy (within the meaning of §1.901-2(g)(3)) is a tax in lieu of an income tax if and only if –
(1) It is a tax within the meaning of §1.901-2(a)(2); and
(2) It meets the substitution requirement as set forth in paragraph (b) of this section.
The foreign country's purpose in imposing the foreign tax (e.g., whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. It is also immaterial whether the base of the foreign tax bears any relation to realized net income. The base of the tax may, for example, be gross income, gross receipts or sales or the number of units produced or exported. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under §1.901-2(e) and (f), respectively, substituting the phrase "tax in lieu of an income tax" for the phrase "income tax" wherever the latter appears in those sections. Section 1.901-2A contains additional rules applicable to dual capacity taxpayers (as defined in §1.901-2(a)(2)(ii)(A)). The rules of this section are applied independently to each separate levy (within the meaning of §§1.901-2(d) and 1.901-2A(a)) imposed by the foreign country.

Except as otherwise provided in paragraph (b)(2) of this section, a foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax.

(b) *Substitution.* – (1) *In general.* A foreign tax satisfied the substitution requirement if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed. However, not all income derived by persons subject to the foreign tax need be exempt from the income tax. If, for example, a taxpayer is subject to a generally imposed income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from insurance is subject to a gross receipts tax and not to the income tax, then the gross receipts tax meets the substitution requirement notwithstanding the fact that the taxpayer's income from other activities, such as the operation of a hotel, is subject to the generally imposed income tax. A comparison between the tax burden of this insurance gross receipts tax and the tax burden that would have obtained under the generally imposed income tax is irrelevant to this determination.

(2) *Soak-up taxes.* A foreign tax satisfies the substitution requirement only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country. If, without regard to this paragraph (b)(2), a foreign tax satisfies the requirement of paragraph (b)(1) of this section (including for this purpose any foreign tax that both satisfied such requirement and also is an income tax within the meaning of §1.901-2(a)(1)), liability for the foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only to the extent of the lesser of –

(i) The amount of foreign tax that would not be imposed on the taxpayer but for the availability of such a credit to the taxpayer (within the meaning of §1.901-2(c)), or

(ii) The amount, if any, by which the foreign tax paid by the taxpayer exceeds the amount of foreign income tax that would have been paid by the taxpayer if it had instead been subject to the generally imposed income tax of the foreign country.

UNITED STATES: FOREIGN GOVERNMENTAL PENSION FUNDS

Revenue Ruling 84-28[1] established that U.S.-source dividends and interest received by a pension fund created by a foreign Government agency will not be exempt from Federal income tax if the fund also covers non-governmental employees.

The text of the Ruling reads:

ISSUE

Whether the income received by a pension trust on certain United States investments is exempt from federal income taxation under section 892 of the Internal Revenue Code if non-governmental employees are participants in the plan.

FACTS

A is an agency of foreign country, FC. A is an integral part of a foreign sovereign within the meaning of section 1.892-1(b)(2) of the Income Tax Regulations.

A has established a pension trust (Fund) for the benefit of its employees. The Fund, a defined benefit plan, provides definitely determinable benefits to its members. The Fund is administered by A's fiscal director. The income of the Fund is used solely to satisfy the obligation of A to participants in the Fund. The Fund's investments in the United States include only stocks and securities of certain United States corporations with regard to which the Fund receives dividend and interest income.

X, a not-for-profit corporation incorporated under the laws of FC, was established to provide certain social services to the residents of FC. In 1981 A admitted employees of X as participants in the Fund. Thus, X began making contributions to the Fund on behalf of its employees. X is neither an integral part of a foreign sovereign within the meaning of section 1.892-1(b)(2) of the regulations nor a controlled entity within the meaning of section 1.892-1(b)(3).

LAW AND ANALYSIS

Section 892 of the Code excludes from gross income and exempts from income taxation the income of foreign governments received from investments in the United States in stocks, bonds, and other domestic securities, from interest on United States bank deposits, and certain income from any other source within the United States.

Section 1.892-1(b)(1) of the regulations states, for the purposes of this section, that a foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States.

Section 1.892-1(b)(4) of the regulations provides that a pension trust established exclusively for employees, or former employees, of a foreign government is a controlled entity if certain requirements are met. These requirements are that the funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government and that the trust forming a part of the pension plan provides definitely determinable benefits (defined benefit plan) so that it may be concluded that the income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

Since non-governmental employees were admitted as participants in the Fund in 1981, the Fund can no longer be viewed as established exclusively for the benefit of employees, or former employees, of a foreign government. Therefore, the Fund is not a controlled entity and the dividend and interest income it receives from United States corporations is not exempt from taxation under section 892 of the Code.

HOLDING

The dividend and interest income received by the Fund in 1981 on certain United States investments is not exempt from taxation under section 892 of the Code because the Fund is not established exclusively for employees of A when non-governmental employees become participants.

1. 1984-8 I.R.B. 12.

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1984 issue. See also Erratum (p. 193 of the May 1984 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

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INDIA:

Non-Resident Indians – Investment and Taxation

By Parimal M. Parikh and Devendra T. Peer

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1. INTRODUCTION

The liberalised scheme for permitting the inflow of resources of non-resident Indians and persons of Indian origin (hereinafter "NRI") by the 1982 budget was not enough to attract their funds for the main reason that there were no tax advantages. Strangely enough, in some cases of large investments the result was that the taxes payable by NRI investors were more than their returns!

In spite of the estimated wealth of NRI being of the order of Rs. 115,000 crores (1 crore = 10,000,000) i.e. more than three-fourths of India's annual gross national product, it is believed that the country could attract not more than Rs. 12 crores from them during the last financial year ended on 31 March 1983. This was obviously not enough since falling foreign exchange reserves can be a cause for great concern.

The Finance Minister Mr. Pranab Mukherjee has recognised the situation that the various schemes designed to attract investments from NRI did not yield any spectacular results and has therefore sought to tackle the problem by offering some more incentives in the 1983 budget. It is hoped that the investments by NRI resulting from the incentives might help the country change its economic scene.

2. DEFINITION OF "RESIDENCE" UNDER THE INCOME TAX ACT 1961

In India income taxation of a taxpayer is determined on the basis of his residential status. For this purpose taxpayers are divided into the following two categories:

– *resident;* and
– *non-resident.*

An individual is treated as resident in India in any year if the fulfills *anyone* of the following conditions:

(i) he is in India in that year for a total period of 182 days or more; or
(ii) has within four years preceding that year been in India for a total period of 365 days or more *and* has been in India for 60 days or more in that year.

An Indian citizen who *leaves India* in any year for the purpose of *employment* outside India is also treated as resident in India if his period of stay in India in *that year* is 182 days or more.

An Indian citizen who is outside India and who comes on a visit to India in any year is treated as resident in India if his stay in India in that year is 90 days or more (instead of 60 days or more as stated above).

Individuals resident in India are further classified as:

– *ordinarily resident;* and
– *not ordinarily resident.*

An individual who is a resident in India according to the provisions stated above is treated as ordinarily resident if:

(i) he is resident in India in nine out of ten years preceding that year; *and*
(ii) he is in India for a total period amounting in all to 730 days or more during the seven years preceding that year.

If he does not fulfill any of the above two conditions he will be treated as *not ordinarily resident.*

An individual is treated as non-resident if he is not resident in any year.

A person who is *ordinarily resident* is liable to tax on income:

(a) which is received or is deemed to be received in India by or on behalf of such person;
(b) which accrues or arises or is deemed to accrue or arise to him in India; and
(c) which accrues or arises to him outside India.

A person who is non-resident is liable to tax in respect of all income from whatever source derived which is received or deemed to be received in India by or on behalf of such person or which is deemed to accrue or arise to him in India. He is not liable in respect of income accruing or arising outside India even if it is remitted to India.

A person who is not ordinarily resident is liable to tax in the same manner as a person who is ordinarily resident, except that the income which accrues or arises to him outside India is not includible in his other income unless it is derived from a business controlled in India or from a profession set up in India.

Thus, the liability to pay income tax in India is dependent on the residential status of a taxpayer.

3. NEW PROVISIONS RELATING TO CERTAIN INCOME OF NON-RESIDENT INDIANS

The Finance Minister has introduced a new Chapter XII A in the 1983 budget covering special provisions relating to certain incomes of non-resident Indians in the new Sections 115-C to 115-I of the Income Tax Act 1961 (hereinafter "ITA"). These provisions have come into force from 1 June 1983.

They are summarised as follows:

Section 115C of ITA is a definition section for certain expressions used in Chapter XII A:

(i) "convertible foreign exchange" means foreign exchange which is for the time being treated by the Reserve Bank of India (hereinafter "RBI") as convertible foreign exchange for the purposes of the Foreign Exchange Regulation Act (hereinafter "FERA"). Section 2(h) of FERA defines foreign exchange as meaning foreign currency and includes all deposits, credits and balances payable in any foreign currency, and any drafts, traveller's cheques, letters of credit and bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency and instruments payable at the option of the drawee or holder thereof or any other party thereto, either in Indian currency or in foreign currency or partly in one and partly in the other;

(ii) "foreign exchange asset" means any specified asset acquired, purchased or subscribed to by the assessee in convertible foreign exchange;

(iii) "specified asset" means shares in an Indian company (private or public), debentures of an Indian public limited company, deposits with an Indian public limited company, Central Government securities, and any other security, deposit or other investment that may be notified by the Central Government for this purpose;

(iv) "investment income" means any income derived from a foreign exchange asset;

(v) "long-term capital gains" means capital gains relating to a foreign exchange asset which is not a short-term capital asset. Section 2(42A) of ITA defines short-term capital asset as meaning a capital capital asset held by an assessee for not more than 36 months immediately preceding the date of its transfer;

(vi) "non-resident Indian" means an individual who is either a citizen of India or a person of Indian origin, and is not "resident" in India. A person shall be deemed to be of Indian origin if he, or either of his parents or any of his grandparents was born in undivided India.

Section 115D of ITA provides that in computing the investment income of a non-resident Indian, no deduction shall be allowed in respect of any expenditure incurred by him nor any allowance granted under any other provisions of the Act. This section hower, does not apply to the income by way of long term capital gains of a non-resident Indian.

Section 115E of ITA provides that income tax on any investment income or income by way of long-term capital gains of a non-resident Indian shall be calculated at a flat rate of 22.5%. It is also provided that this investment income or long-term capital gain shall not be aggregated with his other Indian income for charging income tax on such other Indian income. Thus this will be treated as a separate "block" of income.

Section 115F of ITA provides that in cases where a foreign exchange asset is transferred by a non-resident Indian and the net consideration for the transfer is invested by him within six months in any specified asset or deposited in a *Non-Resident (External) Account (NR(E) Account)* or in notified savings certificates (hereinafter "new asset") any long-term capital gains arising from the transfer shall be exempt from tax. If, however, investment in the new asset is less than the net consideration, such exemption from tax shall be allowed on a proportional basis. It is also made clear that if the new asset so acquired is transferred or converted (otherwise than by transfer) into money, within three years from the date of its acquisition, the capital gain earlier exempted will be charged to tax at a flat rate of 22.5% as capital gains relating to long-term capital assets of the year in which the new asset is transferred or converted (otherwise than by transfer) into money.

Section 115G of ITA provides that a non-resident Indian is exempt from the requirement of filing an income tax return if his income consists of income from specified assets and the tax at source has been deducted from such income.

Section 115H of ITA provides that a non-resident Indian who becomes resident in India shall continue to pay concessional tax of 22.5% on his income from specified assets except dividend income from shares.

Section 115I of ITA provides an option to a non-resident Indian not to be subject to the concessional tax rate of 22.5% if he finds his income for an assessment year to be such as to attract a lower tax rate. However, this option must be exercised by him by making a declaration to that effect along with his income tax return for the relevant assessment year. In such a situation it would be mandatory to file the return and he would be taxed for that assessment year in accordance with other provisions of ITA.

4. EXEMPTION TO NON-RESIDENTS

Income Tax Act 1961 (ITA)

(a) Section 10(4) of ITA exempts from tax interest income of non-residents from securities notified by the Central Government and interest on, or premium on redemption of, any bonds issued by the Central Government under a loan agreement with International Bank for Reconstruction and Development or the Development Loan Fund of U.S.A. or any loan agreement with an industrial undertaking or financial corporation in India and guaranteed by the Central Government.

(b) Section 10(4A) of ITA exempts from tax interest on moneys standing to the credit of a non-resident Indian in an NR(E) Account.

(c) Section 10(4B) of ITA exempts from tax income from interest on 12%/6 year National Savings Certificates to a non-resident Indian provided they are subscribed for in foreign currency.

(d) Section 32 of the Unit Trust of India Act, 1963 exempts from tax, without any upper limit, income from units purchased by a non-resident Indian out of his NR(E) Account or inward remittances in foreign currency in accordance with the provisions of FERA.

Wealth Tax Act 1957 (WTA)

(a) Section 6(ii) of WTA exempts from tax the balance standing to the credit of a non-resident Indian in an NR(E) Account.
(b) Section 5(1)(xvi c) of WTA exempts from tax specifid assets of a non-resident Indian provided they are subscribed for in foreign currency.
(c) Section 5(i)(xxxiii) of WTA exempts from tax a non-resident Indian who has returned to India with the intention of permanently residing in India, in respect of moneys and the value of assets brought by him and value of assets acquired by him out of such moneys. This exemption is available for seven succesive assessment years after his return to India.
(d) Section 5(1)(xxxiv) of WTA exempts from tax a non-resident Indian in respect of the value of any equity shares in a company which is a new industrial undertaking engaged in the manufacture or production of specified items (Schedule II) where such shares form part of the initial issue of the equity share capital made by the company after 31 March 1976.
(e) Section 32 of the Unit Trust of India Act, 1963 exempts from tax, without any upper limit, the value of units purchased by a non-resident Indian out of his NR(E) Account or out of inward remittances in foreign currency in accordance with the provisions of FERA.
(f) Section 3 of WTA is the charging section which lays down that the wealth tax shall be charged at the rates specified in Schedule I.

Part II of Schedule I clarifies in Rule 3 thereof that in case of an individual who is not a citizen of India *and* who is not resident in India the wealth tax payable by him in respect of any assessment year shall be reduced by 50% thereof. Thus, a non-resident of foreign nationality gets a concessional treatment in levy of wealth tax.

Note: For the purpose of clause (b) above, "specified asset" shall have the meaning assigned to it by Section 115C of ITA.

Gift Tax Act 1958 (GTA)

(a) Section 5(1)(ii b) of GTA exempts from tax gifts made by a non-resident Indian out of the moneys to his credit in NR(E) Account in India.
(b) Section 5(1)(ii c) of GTA exempts from tax gifts made by a non-resident Indian to any of his relatives of any amount of foreign currency or foreign exchange remitted from a foreign country.
(c) Section 5(1)(ii d) of GTA exempts from tax gifts of specified assets by a non-resident Indian to any of his relatives in India.

Notes: (i) *For the purpose of clauses (b) and (c) above "relative" shall have the meaning assigned to it by Section 2(41) of ITA as including husband, wife, brother, sister or any lineal ascendant or descendant of that individual.*
(ii) *For the purpose of clause (c) above "specified asset" shall have the meaning assigned to it by Section 115C of ITA.*

5. CONCESSIONS TO NON-NATIONALS

Apart from various exemptions of certain incomes in the hands of non-citizens of India as laid down in Sections 10(6), (8), (9), (15), (26A) of ITA there are a few more specific sections giving concessions only to foreign companies. They may be summarized as follows:

(i) According to Section 115A(1)(a) of ITA a foreign company is taxed at the rate of 25% in respect of its dividend income.
In fact taxing the foreign company at 25% is not in any way concessional in view of the fact that the benefit of the deduction of 60% of dividend income in the hands of a company (Section 80M of ITA) applies only to a domestic company. Furthermore, a foreign company is also not allowed a deduction of any expenditure incurred for earning such dividend.
(ii) According to Section 115A(1)(aa) of ITa, which has been inserted by the Finance Act 1983 with effect from 1 June 1983, interest received by a foreign company from the Government or an Indian concern on moneys borrowed or debts incurred by the Government or such Indian concern in foreign currency is also to be taxed at the rate of 25%.
This means that, although a foreign company is denied the advantage of being taxed at the concessional flat rate of 22.5% as per the new Chapter XIIA of ITA, it can, subject to the permission from RBI under FERA, make portfolio investment in debentures of Indian limited companies or investment in fixed deposits with such companies with the advantage of being taxed at 25%.
(iii) According to Section 115A(1)(b)(ii) of ITA a lump sum royalty received by a foreign company from the Government or an Indian concern in pursuance of an agreement made between them after 31 March 1976 (and where such agreement is made with an Indian concern, it being approved by the Central Government) for transfer outside India of, or importing of information outside India, in respect of any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property is taxed at the rate of 20%; and
the other royalties and fees for technical services received by a foreign company are taxed at the rate of 40%.

The Finance Act 1983 has inserted a new Section 10(6A) with effect from 1 April 1984 according to which tax paid by an Indian counterpart (i.e. the Government or an Indian concern) on the royalty or technical fees payable to a foreign company in pursuance of an agreement made between them after 31 March 1976 and approved by the Central Government is fully exempt from tax. This means the tax paid by the Indian counterpart is not regarded as income of a foreign company.

A notification issued by the Ministry of Finance, Government of India on 11 April 1983 prescribes a 55% rate plus a surcharge thereon of 2.5% as the rate of income tax applicable to a foreign company or a non-resident (other than a company) on the income derived as profits and gains from prospecting for, or extraction, or production of mineral oils under agreements entered into with the Central Government.

Section 115 of ITAS specifies the percentage of computing tax on long term capital gains (LTCG) in case of all companies as follows:

A. LTCG in case of immovable property

(i) Where the company in which the public is substantially interested and the total income of the company (as reduced by LTCG included therein) does not exceed 100,000 rupees at the rate of 40% and
(ii) in any other case at the rate of 50%.

B. LTCG in case of movable property

In case of all types of companies at the rate of 40%.

Section 104(4) of ITA exempts a foreign company from the payment of additional tax on undistributed profits of closely held companies.

6. FOREIGN EXCHANGE REGULATION ACT 1973 (FERA)

Definition of "Person resident in India"

Section 2(p) of FERA lays down specific norms for determining who is a "person resident in India" as follows:

(a) If an Indian citizen has been staying in India at any time after 25 March 1947, he is regarded as a person resident in India.
(b) If an Indian citizen has left India:
 (i) for employment, business, or vocation outside India; or
 (ii) for any other purpose with the intention of staying outside India for an indefinite period of time;
 he is regarded as person not resident in India.
 Even though the word "profession" is not mentioned in Section 2(p) of FERA, if an Indian citizen leaves India to carry on his profession outside India, he will become a resident outside India.
 If an Indian citizen has gone abroad for his studies, a pleasure trip, medical treatment, a business trip, visiting friends or relatives, and other purposes where the intention is not to stay abroad for an indefinite period of time, he will be regarded as a resident in India during his stay abroad.
(c) An Indian citizen who was abroad and was regarded as resident outside India under the preceding provisions will be regarded as resident in India when he returns to India for employment, business, or vocation in India. Similarly, if he returns to India for any other purpose with an intention to stay in India for an indefinite period, he will be regarded as resident in India.
(d) An Indian citizen who has not stayed in India at any time after 25 March 1947 coming to India for employment, business, or vocation, staying with his or her spouse who is resident in India, or for any other purpose, with an intention to stay for an indefinite period, will be regarded as resident in India.
(e) A foreign citizen who has come to stay in India for employment, business or vocation in India will be regarded as resident in India. Similarly, if a foreign citizen stays in India with his or her spouse who is resident in India, the foreigner will be regarded as resident in India during his or her stay in India even if the stay of the foreigner is temporary.
 If a foreigner stays in India for any other purpose and his stay is for an indefinite period he will be regarded as resident in India. If, however, a foreign citizen has become resident in India for the reasons stated in the preceding paragraph he will become a non-resident during the period he is outside India even though that period is of a short duration. For example, if an Indian after becoming a British citizen comes to India for employment, business or vocation in India, he will be regarded as a person resident in India. But during his temporary stay abroad, his status will change and he will be treated as a non-resident.
(f) The residential status of a person does not depend upon that of his or her spouse or parents. For example, if a married Indian citizen has gone abroad for employment, he will become a non-resident. If his spouse, who is otherwise treated as a person resident in India, goes abroad to stay with him for a temporary period, she will continue to be resident in India.

Section 2(q) of FERA defines the expression resident outside India negatively. A person who is not resident in India within the meaning of Section 2(p) above is a person resident outside India.

Thus it may be observed that the definitions of "resident" and "non-resident" are *totally different* under FERA and ITA.

It is possible that a person may be non-resident under FERA but resident under ITA.

Notes:

1. "Non-resident of Indian nationality" means a citizen of India who has gone or stays abroad for either of the following purposes:
 (i) for or on taking up employment outside India; or
 (ii) for carrying on a business or vocation outside India; or
 (iii) for any other purpose in such circumstances as would indicate his intention to stay outside India for an uncertain period.

2. A person shall be deemed to be of Indian origin if:
 (i) he at any time held an Indian passport; or
 (ii) he or either of his parents or any of his grand parents was an Indian and a permanent resident in undivided India at any time.
 "Non-resident of Indian origin" means an Indian citizen who has made his permanent home abroad and has acquired foreign citizenship and also includes descendants of such an Indian who had earlier migrated from India and acquired foreign citizenship. The foreign wife of a non-resident person of Indian nationality or origin is also treated as a non-resident of Indian origin.
 Is is interesting to note the difference in the expressions "person of Indian origin" as defined under FERA and "non-resident Indian" as defined under Section 115C(vi) of ITA.
 Inder the former, the foreign wife of a non-resident person of Indian nationality or origin is treated as a

"person of Indian origin", whereas under the latter, for the purposes of offering tax incentives, she is not considered as "non-resident Indian". This means that, although she may be eligible to invest under FERA, she would be denied the advantage of being taxed at the concessional flat rate of 22.5% as per Section 115E of ITA.

3. *A "non-resident person of Indian nationality or origin" as defined above who returns or stays in India for either of the following purposes:*
   (i) for or on taking up employment in India; or
   (ii) for carrying on a business or vocation in India; or
   (iii) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period
   would cease to be non-resident and will be treated as a person resident in India. Non-resident status of such a person would, however, not be affected during his temporary visit to India.

7. INVESTMENT OPPORTUNITIES FOR OVERSEAS INDIANS

The chart below summarizes the investment opportunities for *overseas Indians* i.e. non-resident Indians and specified bodies (as defined in the chart below) as permitted by RBI under its recent liberalised scheme. The investment opportunities as explained in the chart are subject to certain conditions and fulfillment of Government requirements.

Investment on non-repatriation basis

I Non-resident Indians and specified bodies can freely make portfolio investments in shares/debentures within the overal ceiling of 5% of the total paid up equity capital of the company or each series of convertible debentures, as the case may be. This ceiling of 5% is applicable to all non-resident Indians and specified bodies all over the world. The limit for purchases up to 1% of paid up capital of the company by a single investor however, does not apply here. Non-resident Indians can make deposits with any limited company/firm within the prescribed limits on certain conditions.

II Non-resident Indians and specified bodies can freely invest in units of the Unit Trust of India and the Central Government or State Government securities.

III Non-resident Indians can freely invest in National Plan/Savings Certificates. Specified bodies, however, are not permitted to invest in such certificates.

IV Non-resident Indians can invest in wholly owned proprietory/partnerships concerns or new issues of shares of any public/private limited companies engaged in any business except dealing in real estate i.e. dealing in land and immovable properties for commercial purposes, agricultural or plantation activities. The specified bodies, however, are permitted to invest only in aforesaid new issues and not in proprietory/partnership concerns.

V (i) Non-resident Indians can purchase/sell a residential house without the permission of RBI.
(ii) Non-resident Indians can purchase/sell properties for commercial purposes without the permission of RBI.

CHART

INVESTMENT ON REPATRIATION BASIS

Item	Investment opportunities	Investment through	Investment limits	Investment sectors
I	Portfolio investment in equity/preference shares (See notes 1, 3, 4, 7 and 9 below)	Stock exchange or designated banks	Purchase of shares by a single investor not to exceed 1% of paid up capital issued (subject to the overall ceiling up to 5% of paid up capital)	Any limited company listed on stock exchange
II	Portfolio investment in convertible debentures (See notes 1, 3, 4, 7 and 9 below)	Stock exchange or designated banks	Purchase of convertible debentures of any series in any one company not to exceed 1% of total issue of each series of such debentures. Shares acquired on conversion are in addition to the limit prescribed in Item I above	Any limited company listed on stock exchange
III	Portfolio investment in non-convertible debentures (See notes 1, 3, 4 and 7 below)	Stock exchange	No limit	Existing limited companies or new issues of any limited company
IV	Under 40% equity/preference shares/convertible debentures of new or existing Indian limited companies (See notes 1 and 6 below)	i) A public issue with prospectus	40% of new capital issue	New issue of new or existing limited companies (other than FERA companies) engaged in industrial/manufacturing activities, in hotels (3, 4 or 5 star category) or in hospitals

Item	Investment opportunities	Investment through	Investment limits	Investment sectors
		ii) Other than by a public issue with prospectus	40% of new capital issue limited to Rs. 4 millions	
V	Under 74% equity/preferences shares convertible debentures of Indian limited companies (See notes 1 and 8 below)	Secretariat of Industrial Approvals, Department of Industrial Development, Ministry of Industry, Udyog Bhawan, New Delhi	74% of equity/preference capital of limited companies or partnership firms	Portfolio investment not allowed. New investment or expansion or diversification of existing industrial undertaking consisting of i) Priority industries as listed in Appendix I to the Industrial Licensing Policy 1973 as amended from time to time ii) Any industry provided it exports 60% of output or 75% if in small scale sector iii) Hotels of 3, 4 or 5 star category or hospitals
VI	Investment in specified assets (See note 1 below)	Authorised dealers or Bank or directly	No limit	i) 12%, 6 year National Savings Certificates ii) In savings, fixed or other deposit account with banks iii) Units of Unit Trust of India iv) Central and State Government Securities (other than bearer securities) v) National Plan/Savings Certificates vi) Life Insurance Policies
VIII	Deposits with public limited companies or Government undertakings with limited liability	Authorised dealers or bank or directly	Limited to a period of three years and within the limits prescribed under Companies (Acceptance of Deposits) Rules, 1975	
VIII	100% Export Unit	Secretariat of Industrial Approvals, Ministry of Industry, Udyog Bhawan, New Delhi	100% equity capital	Export oriented unit in selected industries anywhere in India
IX	75% Export Unit	Development Commissioner or Member Secretary SEEPZ/KFTZ Board, Ministry of of Commerce, Udyog Bhawan, New Delhi	100% equity capital	Export oriented unit in: i) SEEPZ, Bombay (Santacruz Electronic Export Processing Zone) ii) KFTZ, Gujarat (Kandla Free Trade Zone)

Notes:

1. Investment opportunities in items I to IX are available to non-resident Indians and specified bodies (excepting investment in National Plan Certificate and Life Insurance Policies in item VI, and items VIII and IX above by specified bodies).
2. "Specified bodies" means overseas companies, partnership firms, trusts, societies and other corporate bodies in which at least 60% holding is by non-resident Indians.
3. Investments in shares/debentures have to be for a minimum period of one year.
4. Repatriation allowed only up to cost of original investment or sale proceeds whichever is less. Capital gains are subject to tax before being allowed for repatriation.
5. "Limited Companies" means limited companies other than FERA Companies.
6. "FERA Companies" means a company with more than 40% non-resident interest.
7. "Portfolio Investment" means investment in the shares/debentures of existing companies quoted on the stock exchange in India.
8. "Small Scale Sector" means an industrial unit with an investment in plant and machinery not exceeding Rs. 2 million.
9. The cut off date for the purposes of determining and monitoring the ceiling is effective from 2nd May 1983.

THAILAND: LOSS COMPANIES

This note was prepared by Mr. M. Hongskrailers of Coopers & Lybrand Associates and Mr. K.S. Jap, principal research associate of the International Bureau of Fiscal Documentation.

In 37 *Bulletin for international fiscal documentation* 8 (1983) at 361-364, a Working Paper was reproduced which was presented at the 12th Meeting of the Study Group on Asian Tax Administration and Research (SGATAR), 7-12 June 1982 in Kuala Lumpur, Malaysia. With respect to loss companies the following was stated:

> Thai tax laws do not have a provision to guard against companies showing continuous losses or low profits. That is, all companies are subject to tax on profit. The tax base is profit. If the company operates at a loss, the company does not have to pay tax, no matter how frequent or severe the loss is. Moreover, losses may be carried forward for 5 years. The only measure that the tax administration has for dealing with continuous loss or low profit companies is to make an audit of the company's accounts. The method of taxing a percentage of the gross contract price is not available for use with loss companies. In Thailand, this method is used for some other purposes. Section 71(1) provides that if any company fails to file a tax return or fails to keep all or any of the required accounts or fails to produce accounts required by the assessment officer for examination, the assessment officer has the power to assess tax at the rate of 5% on the aggregate of either the gross receipts or the gross sales for the accounting period before deduction of expenses. This provision of law is used when the profit is not ascertainable. *Once tax is paid according to this provision, they are not liable to tax on remittance of profits* (emphasis added).

The "tax on remittance of profits" or "remittance tax" (20%) is *not* levied on the remittance of any funds from Thailand to abroad, but rather on the remittance of profits derived by legal entities and partnerships from a business carried on in Thailand. The remittance tax is levied in addition to the corporate income tax (40%) and is, in particular, significant for non-resident corporations carrying on business operations through a branch situated in Thailand. Note that domestic corporations distributing a dividend to a non-resident shareholder are not subject to this tax but must instead withhold a 20% dividend withholding tax.

The remittance tax, therefore, to a certain extent resembles a branch profits tax in that non-resident corporations carrying on business operations in Thailand through a domestic subsidiary or through a permanent establishment located in that country are subject to Thai corporate income tax plus a 20% tax either in the form of a dividend withholding tax or in the form of a remittance tax.

The last sentence of the above citation, however, may create the impression that the remittance tax is not due where a non-resident corporation's branch office in Thailand has been subjected to an estimated tax under Section 71(1) of the Revenue Code. This conclusion would be incorrect since in 1981 the Supreme Court ruled that in such a case the remittance tax must indeed be imposed (Judgement 191/1981). This case may be briefly described as follows.

The plaintiff – a Thai company – hired a Swiss company as a consultant and the Swiss company sent a number of employees to Thailand to advise the Thai company. The Swiss company thus became subject to Thai corporate income tax as a non-resident taxpayer. The plaintiff – which acted as the Swiss company's representative – paid for the living expenses of the Swiss employees and remitted the consulting fees to the Swiss company. It also paid the estimated corporate income tax under Section 71(1) on behalf of the Swiss company (at the time the rate of the tax levied under this Section was 2% on the aggregate of either the gross receipts or the gross sales). The Supreme Court held that the remittance of the consulting fee should be considered as a remittance of profits abroad subject to the remittance tax under Section 70 bis of the Revenue Code.

The above Supreme Court decision confirms the position which was taken by the Thai Revenue in Revenue Department Ruling KK. 0804/22608 dated 18 November 1980 which provided that a Japanese company was subject to both the estimated corporate income tax under Sections 71(1) and 76 bis of the Thai Revenue Code and the remittance tax under Section 70 bis of that Code. The Japanese company concluded an agreement with a Thai company to construct and install a drilling rig for oil and gas exploration in the Gulf of Thailand and to supply the required materials and equipment for the construction. The Japanese company thus acquired a permanent establishment in Thailand under the provisions of the Japanese-Thai tax treaty and could, therefore, be subjected to Thai corporate income tax under Section 76 bis (1) (dealing with foreign companies having agents in Thailand). Since the profits of the Japanese company were not ascertainable, this tax was imposed in an estimated amount as provided for in Sections 71(1) and 76 bis (2). Any profits remitted abroad were also subject to the remittance tax under Section 70 bis.

Considering the view of the Thai Revenue and their confirmation by the Supreme Court, it may be stated that if the profit of a branch office of a foreign company carrying on business operations in Thailand cannot be determined (for whatever reason), the Thai Revenue authorities have the power to assess tax as computed under Section 71(1). If any profits are remitted abroad, they are in addition subject to 20% remittance tax under Section 70 bis. This would even be the case where, according to the foreign company's accounts, the branch office incurred a loss.

However, dividends distributed by a Thai subsidiary of a non-resident parent company to which Section 71 applies are not subject to the 20% remittance tax but to a 20% dividend withholding tax (Section 70).

It should be noted, in this connection, that there are two exceptions to the rule of being subject to the remittance tax:

(1) Foreign companies carrying on the business of international transportation are subject to Thai corporate income tax at the rate of 3% of the *gross receipts*. Consequently, if the foreign company remits profits out of Thailand they are not subject to remittance tax under Section 70 bis.
The *gross receipts* used here refer to: (a) in case of carriage of passengers, "the fares, fees and any other benefits collectible in Thailand"; and (b) in case of carriage of goods, "the freight, fees and any other benefits collectible in Thailand or elsewhere in respect of transport of goods from Thailand".
(2) Branches of foreign companies carrying on the business of petroleum exploration which dispose profits out of Thailand are not subject to the remittance tax under Section 70 bis, because they are exempt under Section 13 of the Petroleum Income Tax Act 1979, as amended.

U.S.A. – Netherlands Antilles Reduced Withholding Tax Rate

The following relevant facts were submitted for consideration. Corp A, a domestic corporation, is engaged in the manufacture and sale of Product F in the United States. United States and non-United States individuals owned the voting stock of Corp A until Date 1. Corp A owns several domestic subsidiaries that manufacture products related to Industry G.

Corp B, a foreign corporation, was established under the laws of the Netherlands Antilles on Date 1. At that time, the foreign shareholders of Corp A contributed their shares of common stock of Corp A to Corp B in exchange for 1X ordinary shares and 2X preference shares in Corp B, which represent 100% of the total outstanding stock of both classes. It has been represented that Corp B owns approximately 3X% of the outstanding voting stock of Corp A.

Corp B maintains an office only in the Netherlands Antilles. The taxpayer represents that it is not engaged in a trade or business in the U.S. through a permanent establishment because it does not have an office or fixed place of business in the U.S. or an agent in the U.S. that has and habitually exercises a general authority to negotiate and conclude contracts on Corp B's behalf or an agent in the U.S. who has a stock of merchandise from which he regularly fills orders on Corp B's behalf. Corp B is entitled to the benefits of Articles 14 of the Netherlands Antilles National Ordinance of Profits Tax of 1940, as amended. In addition to its ownership of common stock in Corp A, Corp B may become involved in certain activities related to its shareholders' other companies, such as financing and management. These activities will not be performed within the U.S.

It is expected that Corp A will pay dividends to Corp B. It has been represented that Corp B will have complete dominion and control over such dividends. Also, Corp B will be under no obligation to transfer any dividends received from Corp A to any other person or entity, not will the dividend received from Corp A be transferred to any other person or entity merely as a result of the receipt of the dividend.

For its tax year ended 31 March 1980, Corp A had gross income of $ 4X, which included $ 5X of interest, dividends, rents from real property and gain from the sale of stock, securities or real property. Effective 1 April 1980, Corp A changed the end of its fiscal year from 31 March to 31 December and for its tax year ended 31 December 1980. Corp A had gross income of $ 6X, which included $ 7X of interest, dividends and rents from real property. For Corp A's 1981 tax year, it had gross income of $ 8X, which included $ 9X of interest, dividends and rents from real property. For Corp A's 1982 tax year, it had gross income of $ 10X, which included $ 11X of interest, dividends and rents from real property.

Article VII(1) of the Convention provides, in part, that the rate of United States tax on dividends derived from a United States corporation by a resident or corporation of the Netherlands Antilles not engaged in trade or business in the United States through a permanent establishment shall not exceed 15%.

Article I(1) of the Protocol provides, in part, that Article VII of the Convention shall not apply to income derived from sources within the United States by any investment or holding company or corporation entitled to any of the special tax benefits provided under Article 13, Article 14 or Article 14A of the Netherlands Antilles' National Ordinance on Profit Tax of 1940, as in effect on 1 September 1963, or to substantially similar benefits granted under any law of the Netherlands Antilles enacted after such date.

Article I(2)(a) of the Protocol provides, in part, that notwithstanding the provisions of Article I(1) of the Protocol, Article VII of the Convention shall continue to apply to dividends derived by any entity, to which Article I(1) would otherwise apply, if the payer of such income is a United States corporation (other than a United States corporation, 60% or more of the gross income of which is derived from interest except to the extent derived by a corporation the principal business of which is the making of loans, dividends, royalties, rents from real property, or gain from the sale or other disposition of stock, securities or real property), 25% or more of the stock of which is owned by such entity.

Section 2.02 of Rev. Proc. 79-40, 1979-2 C.B. 504, provides, in part, that dividends paid to an Antilles corporation shall be subject to withholding of United States tax at the source at the 15% rate prescribed by Article VII of the Convention if the withholding agent receives, prior to the payment of the dividend, a copy of a favorable ruling, described in section 5 of this Revenue Procedure, which has not been revoked, and the requirements of section 505.302 of the Convention withholding regulations are satisfied.

In the present case, for Corp A's tax years ending 31 March 1980, 31 December 1980, 31 December 1981 and 31 December 1982, less than 60% of its gross income for those tax years consisted of dividends and interest, rents from real property and gain from the sale or other disposition of stock, securities or real property. In addition, Corp B is incorporated under the laws of the Netherlands Antilles and is not engaged in trade or business in the United States through a permanent establishment or otherwise.

Accordingly, based upon the facts and representations made, the amounts paid as dividends by Corp A to Corp B will be subject to withholding of U.S. tax at the source at the 15% rate prescribed by Article VII of the Convention, as extended to the Netherlands Antilles.

Pursuant to section 5.02 of Rev. Proc. 79-40, this favorable ruling wil apply until Corp B ceases to qualify under Article I(2)(a) of the Protocol. If any of the facts upon which this ruling is based subsequently change, Corp A must promptly notify the Commissioner of such change.

In accordance with section 9.21 of Rev. Proc. 83-1, 1983 1 I.R.B. 16, a copy of this letter is to be attached to any return to which it is relevant with respect to a completed transaction.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

JAPAN:

The 1984 Tax Amendments

By Makoto Miura

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BACKGROUND OF THE TAX REFORM

The main thrust of the tax amendments for fiscal year (FY) 1984 is that for the first time since 1977 individual income tax was reduced, whereas the rates of corporation income tax and several indirect taxes were raised. The Budget for FY 1984 shows with respect to taxes the following reductions and increases:

Tax reductions (in billions of yen)		
Individual income tax		
(a) Increase of personal deductions	662	
(b) Expansion of the employment income deduction	199	
(c) Increase of other allowances	50	
Investment tax credit	52	
Total		963[1]
Tax increases		
Individual income tax (change of tax rates)	31	
Corporate income tax		
(a) Increase of tax rates	430	
(b) Abolition of the possibility to defer payment of tax	70	
(c) Suspension of loss carry-back provisions	60	
Increase of rates of indirect taxes		
(a) Liquor tax	320	
(b) Petroleum tax	67	
(c) Commodity tax	35	
Other tax increases	15	
Total		1,028[2]
Balance (tax increase)		65

Taxpayers have been complaining about the increasing tax burden caused by the inflation-induced increase in price and wage levels without any adjustment of the tax rates (bracket creep) and deductions during the last 6 years. For example, the average level of wages and salaries rose by 30.1% from 1977 to 1982, while the average income tax burden increased by 70.9% during the same period of time. Thus, the rate of increase of income tax has been higher than that of nominal income and this was mainly caused by the progressive income tax rates and stable amounts of deductions. This has now become a major political issue.

During the general elections which were held in December 1983, the Government party (LDP) promised solemnly that income taxes would be reduced. At the same time, the Nakasone Cabinet announced that it would not increase taxes. However, the majority of the taxpayers did not believe that the Government would be able to perform such a feat and the above figures show that in fact taxes have again been increased.

It must be conceded that it will not be possible for any Japanese government to reduce taxation because of the large budget deficit, which has been increasing since the first oil crisis in 1973. Part of the deficit has been covered by bond loans, but the accumulation of such government loans has, of course, resulted in the increase of debt service expenditures. The ratio of these debt service expenditures to total government expenditure was only 3.7% in 1970, which slowly increased to 4.9% in 1975. After that, the ratio rapidly increased until it reached 18.1% in the 1984 Budget. In order to get the deficit down, the Government tried to cut expenditure, especially in the field of social welfare and education. However, this policy met with much opposition from the people and it has become clear that these large scale budgetary curtailments are very difficult to accomplish. This is the reason why the Government eventually had to increase taxes. Although Prime Minister Nakasone denied that the introduction of an overall indirect tax was envisaged, Mr. Takenaka, the Minister of Finance, announced in Parliament that the Government is currently studying the possibilities of a value-added tax (in the form used in the European Common Market) to be introduced in FY 1985 or 1986. At the same time, the *Japan Times* reported on 18 February 1984 that: "Michio Watanabe, senior deputy secretary general of the LDP, said that the party would study tax increases for fiscal year 1985, immediately after the current Diet session ends in May – one of the major ways being considered for such large-scale tax increases is the value-added tax implemented in the European Community, as the LDP leaders indicated."

OUTLINE OF THE TAX REFORM

Individual income tax

Increase of deductions

The basic personal deduction and the deductions for spouses and dependents are raised from 290,000 yen to 330,000 yen. The deductions for physically handicapped persons, elderly persons, widows and widowers and working students are increased from 230,000 yen to 250,000 yen and the deduction for severely disabled persons is increased from 310,000 yen to 330,000 yen.

The employment income deduction is amended in the following manner:

1. Approximately US$ 4.3 billion.
2. Approximately US$ 4.5 billion.

	1983 (in yen)	1984 (in yen)
Minimum deduction	500,000	570,000
Deduction is 40% if employment income is less than	1,500,000	1,650,000
Deduction is:		
600,000 + 30% of excess over 1,500,000 if employment income is between	1,500,000–3,000,000	
660,000 + 30% of excess over 1,650,000 if employment income is between		1,650,000–3,300,000
Deduction is:		
1,050,000 + 20% of excess over 3,000,000 if employment income is between	3,000,000–6,000,000	
1,155,000 + 20% of excess over 3,300,000 if employment income is between		3,300,000–6,000,000
Deduction is:		
1,650,000 + 10% of excess over 6,000,000 if employment income is between	6,000,000–10,000,000	
1,695,000 + 10% of excess over 6,000,000 if employment income is between		6,000,000–10,000,000
Deduction is:		
2,050,000 + 5% of excess over 10,00,000 if employment income is over	10,000,000	
2,095,000 + 5% of excess over 10,000,000 if employment income is over		10,000,000

Consequently the total exempt amount of annual taxable income for a salaried worker is to be raised from 2,079,000 yen to 2,357,000 yen.[3]

Rate change

On the whole, the tax rates are reduced but the effect of the rate increase for the lowest incomes is an increase of the individual tax on taxpayers *as a group*. Another result of the current rate change is that high income taxpayers benefit most. For example, a taxpayer who is married and has two children and who receives employment income of 3,000,000 yen receives a tax reduction of

1983 Taxable income (thousand yen)	Tax rate	1984 Taxable income (thousand yen)	Tax rate
up to 600	10%	up to 500	10.5%
600– 1,200	12%	500– 1,200	12 %
1,200– 1,800	14%	1,200– 2,000	14 %
1,800– 2,400	16%	2,000– 3,000	17 %
2,400– 3,000	18%	3,000– 4,000	21 %
3,000– 4,000	21%	4,000– 6,000	25 %
4,000– 5,000	24%	6,000– 8,000	30 %
5,000– 6,000	27%	8,000–10,000	35 %
6,000– 7,000	30%	10,000–12,000	40 %
7,000– 8,000	34%	12,000–15,000	45 %
8,000–10,000	38%	15,000–20,000	50 %
10,000–12,000	42%	20,000–30,000	55 %
12,000–15,000	46%	30,000–50,000	60 %
15,000–20,000	50%	50,000–80,000	65 %
20,000–30,000	55%	over 80,000	70 %
30,000–40,000	60%		
40,000–60,000	65%		
60,000–80,000	70%		
over 80,000	75%		

15,475 yen whereas a person with the same family situation but earning 20,000,000 yen benefits from a tax reduction of 284,000 yen i.e. while the income of the latter person is 6.67 times the income of the former, he receives a tax reduction which is 18 times the reduction of his poorer colleague.

Inhabitant tax

In addition, the inhabitant tax (local income tax) will also be reduced. The basic deduction and the deductions for spouse and dependents will be raised from 220,000 yen to 260,000 yen. The deductions for physically handicapped persons, elderly persons, widows and widowers as well as for working students will be increased from 210,000 yen to 240,000 yen. With respect to the tax table, only the lowest rate is increased, i.e. from 2 to 2.5%.[4]

Corporate income tax

The corporate income tax rate will be temporarily increased – FY 1984 and FY 1985 – as follows:

3. The amount of 2,357,000 yen (approximately US$ 10,250) is computed as follows: employment income deduction (872,100 yen) + deductible social security premium (164,900 yen) + personal deductions (1,320,000 yen).
4. The rates for the (municipal) inhabitant tax for 1984 will be:

Taxable income (yen)	Tax rate
– 300,000	2.5%
300,000– 450,000	3 %
450,000– 700,000	4 %
700,000– 1,000,000	5 %
1,000,000– 1,300,000	6 %
1,300,000– 2,300,000	7 %
2,300,000– 3,700,000	8 %
3,700,000– 5,700,000	9 %
5,700,000– 9,500,000	10 %
9,500,000–19,000,000	11 %
19,000,000–29,000,000	12 %
29,000,000–49,000,000	13 %
49,000,000– –	14 %

Note that there is also a prefectural inhabitant tax which is levied at a 2% rate on annual incomes up to 1,500,000 yen and at 4% on the excess.

	1983		1984 and 1985	
	Undistributed profits	Distributed as dividends	Undistributed profits	Distributed as dividends
Ordinary corporations:				
(1) Corporations with capital not in excess of 100,000,000 yen earning 8,000,000 yen or less	30%	24%	31 %	25 %
(2) Others	42%	32%	43.3%	33.3%
Cooperatives, public interest corporations and other special corporations	25%	21%	26 %	22 %

Inhabitant tax

The increase of the corporate income tax rates will result in an increase of the inhabitant tax levied on corporations since the prefectural and municipal inhabitant taxes are levied as a percentage of the national corporate income tax. The combined impact of these taxes ranges between 17.3% and 20.3% of a corporation's tax assessment. Both the prefectural and municipal inhabitant taxes also have a "per capita" component. These will be increased as follows:

Capital plus Reserve Fund	Employees	1983 thousand yen	1984 thousand yen
more than 5,000,000,000 yen	more than 50	1,500	3,750
	50 or less	460	1,150
1,000,000,000 – 5,000,000,000 yen	more than 50	900	2,250
	50 or less	360	900
100,000,000 – 1,000,000,000 yen	more than 50	200	500
	50 or less	100	250
10,000,000 – 100,000,000 yen	more than 50	72	180
	50 or less	60	150
not more than 10,000,000 yen	more than 50	52	130
	50 or less	20	50

The "per capita" levy has, therefore, increased 250%.

Investment relief

Certain taxpayers who manufacture or purchase machinery or equipment for more efficient use of energy are entitled to a tax credit of 7% of the acquisition cost. Alternatively, such taxpayers may elect to take a special 30% initial depreciation deduction in the first year. However, this relief is only given to corporations which are specified by law and indicated under a cabinet order as "permanently depressed industries" or to certain small and medium-sized enterprises. A new measure is that corporations which specialize in high-tech business and products or which purchase buildings in certain areas where high-tech industries are concentrated (Technopolis Areas) will be entitled to the special 30% initial depreciation deduction in the first year. These relief measures will be applicable in FY 1984 and FY 1985.

Increase of indirect taxes

Liquor tax

Sort of product	Present retail price yen	Present tax (a) yen	Tax increase (b) yen	b/a %
Sake (Japanese rice wine)				
Special class (1.8 l.)	2,550	917	179	19.5
1st class (1.8 l.)	1,800	441	95	21.5
2nd class (1.8 l.)	1,350	169	25	14.8
Shochu (Japanese liquor)				
Group A	940	105	36	34.3
Group B	1,030	73	18	24.7
Beer (633 ml)	285	127	25	19.7
Wine (720 ml)	780	32	11	34.4
Whisky				
Special class (760 ml)	2,900	1,334	261	19.6
1st class (720 ml)	1,470	583	144	24.7
2nd class (640 ml)	630	159	30	19.5
Spirits (720 ml)	690	201	59	29.4
Liquor (720 ml)	900	76	23	30.3

Commodity tax

The commodity tax will be levied on certain goods which were formerly outside its scope (A). For other goods its rate will be increased (B). The main categories of A and B are:

A.	*Sort of product*	Tax rate	
	Video disk players	15%	
	Electromagnetic cooking utensils	15%	
	Surfboards	10%	
	Hang-gliders	10%	
	Magnetic tapes for recording	10%	
	Non-automatic washing machines	10%	
B.	*Sort of product*	Present tax rate	New tax rate
	Passenger automobiles	22.5%	23%
	Small passenger automobiles	17.5%	18.5%
	Trucks	10 %	10.5%
	Small trucks	5 %	5.5%

Petroleum tax

The tax rate is raised from 3.5% to 4.7%.

Increase of the automible tax

The automobile tax (which is a local tax) is imposed on vehicles registered in the prefecture. It is levied as a standard annual tax whose amount is dependent on the type of vehicle. It has now been proposed to increase the tax by 5 to 15%. For instance, the tax with respect to a passenger car with a cylinder volume in excess of 6,000 cc. will be 148,500 yen (currently 129,000 yen). However, for a car for commercial use only the tax will be lower, i.e. 54,500 yen (currently 52,000 yen).

CONCLUSION

In the author's opinion, very few taxpayers are satisfied with the 1984 tax amendments. Those taxpayers who wanted a reduction of the individual income tax complain that the reductions proposed are much too small. The workers expect that their net wages will be increased by the tax reduction, but this will hardly be the case. Enterprises expect that the Government will give substantial relief in a period of depression, but they will be faced with higher rates of corporate income tax. In reality, the Government is not prepared to give a tax reduction because of the enormous budget deficit. Experts in the field of public finance have little sympathy for the resistance against tax increase – especially with respect to the resistance against the introduction of the general value-added tax – since they believe that the tax burden in Japan is substantially lower than in most of the European countries and the United States. After all, the ratio of total tax revenue to gross national income in Japan is only 24.2% (FY 1984).

Other experts advocate increasing the tax revenue by a better tax administration. It should be possible to tap the resources of the "underground economy" and thus collect a substantial amount of tax which would otherwise be avoided. However, it should also be appreciated that this manner of increasing tax revenue has its limits.

The main issue at present is the choice between more inflation or the increase of taxes and the Japanese Government and the Japanese people will soon have to decide which is going to happen.

Federation of Economic Organizations Versus Unitary Taxation[1]

In February 1984 Keidanren (Japan Federation of Economic Organizations)[2] sent a delegation to the United States to urge abolition of the worldwide unitary method of taxing corporate income that has been adopted by more than 10 states. Under worldwide unitary taxation, all the income of a corporate group is combined and subject to taxation in a state. Stated more specifically, taxation of the income of a subsidiary located in a particular state in the United States is calculated on the basis of the property, payroll, and sales of not only the subsidiary concerned but also the subsidiary's parent company and all other subsidiaries of the parent, regardless of their location. This constitutes the extra-territorial application of law by the local state, and it also results in double taxation. Furthermore, companies are forced to spend an inordinate amount of time and money to translate documents, convert currency figures, and revise their financial statements to meet complicated requirements for disclosure of information.

Below is a summary of the position paper distributed in the United States by the Keidanren delegation. Unless states eliminate worldwide unitary taxation, it warns, Japanese companies will channel their investments elsewhere. And if this tax method spreads to other parts of the globe, it will be the United States and its multinational corporations that will be hurt the most.

We regret that more than 10 states in the United States have adopted the unitary method of taxation to tax the worldwide income of multinational enterprises, because this impedes Japanese investment in the United States just at the time that positive steps by the Japanese business community have been increasing. Worldwide unitary taxation results in taxing the foreign-source income of foreign entities beyond the jurisdiction of the individual state, causing what amounts to double taxation and giving rise to arbitrary application of the tax. It also deviates from international agreements on taxation based on separate accounting.

These factors hamper foreign companies' willingness to invest in those states that apply the worldwide unitary method of taxation. We are concerned that some of our member companies are reconsidering their investments or refraining from investing in states with unitary taxation.

We would like to reiterate President Reagan's statement on international investment, which we fully support: "Both home and host country economies benefit from an open international investment system . . . . The United States welcomes foreign investment and accords foreign investors the same fair, equitable and nondiscriminatory treatment it believes all governments should accord foreign investment."

Keidanren has surveyed its member companies on their experience with the worldwide unitary tax now being implemented in more than 10 U.S. states and has examined the issue in the light of the views stated above. We have concluded that we oppose the worldwide unitary tax for the following reasons.

Worldwide unitary taxation oversteps the tax jurisdiction of the state and results in double taxation

Beyond tax jurisdiction

In practice, the worldwide unitary tax method imposes tax on the foreign-source income of entities residing outside the state and even outside the United States by combining the income of all corporations in the group to which the resident corporation belongs and apportioning it to each geographical area. This constitutes the extraterritorial application of law by the local state, and does not reflect the actual state of transactions. For example, the U.S. subsidiary of a Japanese company usually has nothing to do with the income that the parent company earns from transactions with its subsidiaries located in Southeast Asia or Europe. But under the worldwide unitary taxation system, part of the income earned from such transactions will be apportioned to the state in which the U.S. subsidiary has its domicile, even though the U.S. subsidiary was not involved in earning this income.

We have difficulty understanding why a state has the authority to tax income totally unrelated to that state, espe-

1. This pamphlet was reproduced from KKC BRIEF No. 17 of March 1984 published by the KEIZAI KOHO CENTER (Japanese Institute for Social and Economic Affairs) where it appeared under the title: "How U.S. States can lose business investment; Keidanren Statement on Worldwide Unitary Taxation". KKC BRIEF is an occasional publication of the Keizai Koho Center. Issued several times a year, it provides, in a concise format, news on the activities and views of Keidanren (Japan Federation of Economic Organizations) and other private Japanese economic organizations, as well as information on particular industries and the Japanese economy in general. KEIZAI KOHO CENTER is a private nonprofit organization that works in cooperation with Keidanren to provide information on the Japanese economy.

2. KEIDANREN (Japan Federation of Economic Organizations) is a private nonprofit economic organization representing all branches of economic activity in Japan. While maintaining close contact with economic sectors at home and abroad, Keidanren endeavors not only to find practical solutions to economic problems but also to contribute to the sound development of the economies of Japan and other countries around the world. As of 24 January 1984, Keidanren's membership numbered 117 associations and 832 corporations. The association members include trade associations and regional economic organizations. The corporate members are leading Japanese enterprises and foreign companies operating in Japan.
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cially when the state in turn provides none of the benefits normally furnished to a taxpaying entity, such as infrastructure and workers' education and training programs. The power to impose taxes derives from the general benefits and protection that a government provides to taxpayers and their property. Where no such benefits exist, the power to tax is not clear. Therefore, a tax authority is empowered to tax only within its proper jurisdiction or territorial boundaries. Tax jurisdictions must be respected, for a government's taxing of income beyond its jurisdiction contradicts international practices and allows unreasonable taxation.

Inevitable double taxation

Under the system of separate accounting, corporate group members not doing business in the United States are taxed on the income they earn outside the United States by the local authorities where they are domiciled or doing business. Double taxation is inevitable when the profits of foreign corporations are included in the income earned in a unitary state. Furthermore, bilateral tax treaties can not relieve such corporations from double taxation, because the federal government has no authority over local taxes.

Corporation A reports, "Even though our U.S. subsidiary operated at a deficit in 1976 and 1977, it was still taxed under the worldwide unitary method. After turning a profit in 1978, its income under the worldwide unitary method was estimated to be 8.4 times higher than its income under the system of separate accounting, and a tax totaling 93 times the amount under the separate accounting system was imposed."

Corporation B states, "Even though we recorded a loss in the 1980 fiscal year, we were assessed tax totaling 294 times the minimum amount."

The sum of the tax burden of Corporation C from 1979 through 1982 by the worldwide unitary method gives the corporation an effective tax rate of 101%, which means that all its profits have been siphoned off by the state.

Corporation D reports, "We were charged penalties amounting to 14 times our tax according to the separate accounting system in fiscal 1981, 42 times in fiscal 1982, and 21 times in fiscal 1983."

Corporation E says, "After several years of paying taxes according to the system of separate accounting, we were suddenly told that our taxes had to be calculated by the worldwide unitary method. Now we must pay additional taxes and interest ranging from 4 to 35 times the tax we paid in previous years."

Corporation F reports, "In 1981 we received notice that we were being assessed for additional taxes as far back as 1969. The interest was so high that we ended up having to pay four to five times the tax amount we had previously paid under the separate accounting system."

The taxable income that serves as the base for calculating the additional tax has already been taxed in Japan, where the parent company is domiciled. For a state to tax the same income again is a clear case of double taxation.

Particularly during the initial period of an investment, the unitary tax method tends to result in double taxation, especially when the local operation is in the red. Corporation G therefore makes it a policy to estimate a higher tax rate than normal when it starts up new projects in states where worldwide unitary taxation has been adopted.

In the case of the Caterpillar Tractor Company, worldwide combined reporting reduced its state taxable income. Such undertaxation, however, does not justify the overtaxation of others. Two wrongs do not make a right.

Worldwide unitary taxation is impractical

Vague concept

Fair and just taxation is the fundamental principle of modern taxation and is indispendable in obtaining the confidence of taxpayers in the tax system. In this regard, it is important that the procedures for calculating taxable income be set forth clearly. The procedures should also induce in both taxpayers and the authorities a willingness to abide by the system. A tax system that does not have clear procedures and relies on the arbitrary judgment of tax authorities is deficient and inappropriate.

Under the unitary tax method, arbitrary treatment by tax authorities is inevitable because there is no clear definition of a "unitary business." Some states apply a "three unities" test, in which they assess the unities of ownership, use, and operation. Ownership aside, the definitions of "use" and "operation" are very vague.

For instance, Corporation H was judged to be part of a unitary business by mere reason of its holding more than 50% of the stock of a U.S. subsidiary, even though the unities of use and operation were absent. There was no exchange of raw materials or goods between the Japanese parent and the U.S. subsidiary, no centralization of managerial and supervisory functions on the part of the parent, and no financing or loan guarantees provided to the subsidiary by the parent.

In unitary taxation, the total income of a corporate group is generally distributed among the group's member companies giving equal weight to the three factors of property, payroll, and sales. No recognition is given to the fact that these three factors do not carry equal weight in the incomes of many multinational enterprises.

Also, when income is apportioned by these three factors, the higher the level of these factors are, the more income is apportioned to that company. Such levels are higher in the United States than in the developing countries, so states with a worldwide unitary tax are apportioned more income than are the developing countries. But the economic and political risks are much higher in the developing countries than in the United States. Investment will not be made where the risks are great unless the anticipated return is higher than that of an investment in the United States. Apportioning income by the three-factor formula gives no consideration to this fact.

Bank I reports, "Our California subsidiary employs 4,000 people and is contributing to the economic welfare of that state. However, its payroll factor is more than twice as large, and in some years even four times as large, as its sales and property factors. Because of this, its income apportionment is abnormally high."

The more broadly the unitary tax is applied in the economically diverse areas of the world, especially with regard to the value of property, payroll, and sales, the greater will be the negative impact of this irrational and ambiguous method of taxation.

We must also point out that the broader the application of the unitary tax method, the greater the potential for instability of state revenues due to ambiguity. Although the worldwide unitary tax method may enable states to collect income tax from corporations domiciled in the state that have earned no income in a particular year, if the combined income of a unitary business shows a loss, it will result in a tax reduction or refund even if the corporation domiciled in the state turned a profit. This instability of revenue will be greatly compounded as the unitary concept spreads to vastly diverse areas of the world. Our members report that because of this unpredictability, tax authorities tend to implement unitary taxation in an arbitrary manner.

Corporations J and K report that worldwide unitary taxation is applied in some years but not in others. And many other Keidanren member corporations say that they were being taxed only on the combined incomes of the U.S. subsidiary and Japanese parent, but suddenly and without any notification as to which companies were to be considered part of their unitary business, the state tax authorities informed them that they would have to combine the incomes of all affiliated companies.

Intolerable paperwork and costs

It is desirable that tax payment procedures be made as simple as possible. Tax methods that require an inordinate amount of expense and effort in relation to the amount of tax to be paid or that are likely to lead to frequent disputes should not be adopted.

The worldwide unitary method of taxation is both troublesome and costly because of its complicated concept of taxation and computation of taxable income. State tax authorities and companies alike have difficulty calculating tax amounts by the correct procedures. As a result, arbitrary juidgments by the tax authorities prevail, and taxpayers are forced to carry out costly, time-consuming procedures in order to comply.

"We have to revise financial statements that were prepared in Japan to comply with the U.S. standards of accounting and tax code," complains Corporation J. "In addition, we also have to explain in detail in English the differences between the Japanese and U.S. accounting methods. This is an enormous task." Corporation A adds, "Individual adjustments in the values of property and sales also create a lot of work."

Corporation L says, "It takes time to collect information from foreign subsidiaries outside the United States in order to comply with the worldwide unitary method of taxation. Adjusting special allowances and depreciation allowances so that they comply with U.S. accounting standards is extremely time-consuming."

Bank I reports, "The California state tax authorities told us that we had to calculate the amounts in the bad-debt reserves of the parent bank and affiliated banks by the California method. The paperwork, which involved going back a number of years and computing these amounts, was tremendous."

When state tax authorities unilaterally decide that foreign-source income should be included in taxable income, it is the companies that are responsible for providing any evidence to the contrary. However, it is impossible for companies to provide such evidence because of all the effort and money that must be put into deciding which companies are part of the unitary business, computing taxable income, and apportioning worldwide income. This is especially true for such multinationals as trading companies, which have numerous subsidiaries all over the world.

Corporations E and L report, "Even though we object to unitary taxation, arguing with the tax authorities would only cost us more. Instead, we get our tax reduced by negotiating with them." A number of companies also report that when the rate of penalty was raised, they paid the additional tax assessed, but registered a protest so that they will be able to claim a refund if their claim is upheld.

Worldwide taxation is detrimental to the sound development of capital exchange

Negative impact on investment

It is desirable that taxation have as neutral an effect as possible on corporate decisions where the worldwide unitary tax is being enforced. However, the managements of corporations domiciled in unitary states are caught in a dilemma of being unable to estimate their taxes or formulate a business strategy because the connection between their business performance and the amount of tax they must pay has been severed. Moreover, if the tax authorities arbitrarily change the tax calculation method, the willingness of corporations to invest will be severely hampered. Japanese companies are in fact becoming reluctant to invest in states that have adopted the worldwide unitary tax method.

According to Corporation C, "No state is 'safe' to invest in, because the worldwide unitary tax can be adopted so readily."

Corporation F reports, "We decided not to invest in California because it has a worldwide unitary tax, and set up operations in Alabama instead."

Corporation M says, "We had been considering investing in Oregon, but dropped it in favor of North Carolina."

Corporation N is considering pulling out of California.

Corporations F and J report, "We would like to expand our facilities in California, where we already have a factory, but we probably will not."

Corporation A says, "We place top priority on investing in those states that do not apply the world-wide unitary method of taxation."

Corporation D says, "In the future we will have to rethink our investment strategy because more than ten states have been applying the worldwide unitary tax."

Corporation O says, "We have been audited in the past, but we were never notified that we would be taxed on a worldwide unitary base. However, we are concerned about the possibility of being taxed unreasonably by the worldwide unitary method, so from now on we will consider new investments only in nonunitary states."

Corporation P asserts, "We are not making new investments in states that have been applying the unitary method of taxation."

Many Keidanren member companies regard the worldwide unitary method of taxation as a negative factor in deciding where to make their future investments.

Confusion in the international tax system

Because nations have grown more economically interdependent and international transactions have rapidly increased, it is necessary that efforts be made to harmonize nations' tax methods. The United States and other OECD member countries have worked hard toward this goal, the result being the establishment of an internationally accepted system. Tax treaties based on this system have been concluded among OECD nations to avoid taxing the same income twice in the recognition that double taxation has the effect of distorting the flow of goods, services, and investments. Such efforts have contributed greatly to the expansion and development of the world economy.

Under these circumstances, it is most regrettable that a concept of taxation that differs so greatly from internationally accepted principles and discourages the further expansion of trade and investment is being applied in the United States, a nation that should be the main pillar of the free economic system. Worldwide unitary taxation not only brings to naught the efforts that nations have persistently devoted to the important issue of eliminating double taxation. If developing nations follow suit in implementing worldwide unitary taxation, the framework of international taxation that has been built up so far will collapse, and the development of international trade and investment will come to a complete halt with the ensuing scramble to collect as much tax as possible. If this should happen, the United States, which has more multinationals than any other country, would suffer the most damage.

CONFERENCE DIARY

JULY 1984

BNA International Inc.: Comparative Law and Practice in Transnational Business Operations and Transactions (including: comparative tax implications of foreign transactions) (Seminar) (sponsored by the Dickinson School of Law and the Bureau of National Affairs Inc.) London (United Kingdom), 2-5 July (English).

International Corporate Tax Planning: Residence and controlled foreign companies; double tax relief; structuring overseas operations; tax systems in overseas countries; intercompany pricing and charges. Eastbourne (United Kingdom), 3-5 July (English).

AUGUST 1984

National University of Singapore: Singapore Conferences on International Business Law (Conference 2: current issues in international financial law) (sponsored by the Development Bank of Singapore Ltd.) (including: islamic banking and finance; general contractual issues (taxation implications); bond issues; syndicated loans). Singapore, 15-18 August (English).

SEPTEMBER 1984

International Bar Association: Twentieth Biennial Conference (including: measures against treaty shopping; important new developments in national tax legislation as well as current activities of international organisations in the tax field; residence and transfer of residence of bodies corporate). Vienna (Austria), September 2-7 (English).

Commonwealth Association of Tax Administration (CATA): Technical Conference 1984 (including: incentives in tax systems for (a) economic, (b) social objectives). Apia (Western Samoa), 6-12 September (English).

International Tax Planning Association: Monte Carlo Workshop. Monte Carlo (France), 13 and 14 September (English).

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina), 16-21 September (English, French, German, Spanish).

The Bureau of European Taxation & Trade: Double taxation relief in Europe (symposium). London (United Kingdom), 24 September (English).

OCTOBER 1984

University of Miami: 39th Annual University of Miami Tax Conference. Miami (U.S.A.), 15-19 October (English).

NOVEMBER 1984

International Tax Planning Association: Hong Kong Seminar. Hong Kong, 26 and 27 November (English).

FOR FURTHER INFORMATION PLEASE WRITE TO:

BNA International Inc.: 17 Dartmouth Street, London SW1H 9BL (United Kingdom).

The Bureau of European Taxation & Trade: Co-ordinator Miss Audrey Evelyn Bone, 606 Bryer Court, Barbican, London, EC 2 (United Kingdom).

Commonwealth Association of Tax Administration (CATA): Marlborough House, Pall Mall, London SW1Y 5HX (United Kingdom).

International Bar Association: 2 Harewood Place, Hanover Square, London W1R 9HB (United Kingdom).

International Corporate Tax Planning: contact Professional Development Services Department. The Institute of Chartered Accountants in England & Wales, P.O. Box 433, Moorgate Place, London EC 2P 2BJ (United Kingdom).

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

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

National University of Singpore: c/o Faculty of Law, Singapore 0511 (Republic of Singapore).

University of Miami - Conference Center. School of Continuing Studies, 400 S.E. Second Avenue, Miami, Florida 33131, U.S.A.

Prospects of the Taipei Offshore Banking Center

By I-Shuan Sun

Dr. I-Shuan Sun is chairman of The Export-Import Bank of China, Taipei, Taiwan.

INTRODUCTION

The first Asian dollar market was established when the Singapore Government approved a plan to start offshore banking operations in 1968. Since them the Asian Currency Unit (ACU) market in Singapore has not only grown rapidly in size, but has also upgraded the quality of Singapore's financial services and openend up many new investment and job opportunities. Thus, by establishing an offshore banking business, a country can foster its economic growth and prosperity.

Taiwan is one of four newly industrialized countries in Asia whose performance in economic development has long been recognized by all nations in the world. To meet the demands of its rapidly developing economy, the Government has revamped its financial system and is constantly striving for the improvement of financial services. It has liberalized the requirements for establishing branches in Taiwan by foreign banks. It has set up money and foreign exchange markets to effect liberalization of interest rates and exchange rates. It is working to speed up the automation of financial operations, and, thus far, the financial sector has shown a marked growth. Now the Government hopes to follow Singapore by establishing an offshore banking center in Taipei for expanding financial services to other parts of the world and to attract foreign investments and international financial activities, so that Taiwan will be another important financial center in the Far East.

REQUIREMENTS FOR THE TAIPEI OFFSHORE BANKING CENTER

Some of the important prerequisites for the establishment of an offshore banking center in Taipei – such as stable political and financial environments, sound banking system, etc. – are already in existence. To insure its smooth foreign exchange operations, the Government has dispatched a number of people to visit several international financial centers for on-the-spot observations. Young bankers were sent abroad for training in the foreign exchange operations in various financial centers and banks. Finally, special legislation is needed to give OBU (offshore banking unit) banking institutions the necessary incentives in tax exemptions and financial management in order to be competitive with other offshore banking centers. Such legislation was completed before the end of 1983, when the "Act for Offshore Banking Operations" was passed by the Legislature and promulgated. It is expected that in July 1984 the offshore banking center will be in operation.

The following types of bank may, through their respective head offices, apply to the Ministry of Finance for authorization to establish an offshore banking branch, with independent books of account, to conduct offshore banking operations:

(1) foreign banks appointed by the Central Bank of China to conduct foreign exchange operations within Taiwan;
(2) foreign banks with Government approved representative offices;
(3) qualified reputable foreign banks approved by the competent authority;
(4) domestic banks appointed by the Central Bank of China to conduct foreign exchange operations.

SCOPE OF OFFSHORE BANKING OPERATIONS

According to the stipulations of the "Act for Offshore Banking Operations", banks operating in the offshore banking center should be principally in the form of branches. Their scope of business is limited to transactions outside the national boundaries of Taiwan, that is, they will channel funds from overseas and lend money to overseas customers. The Act specifies that an offshore banking branch may conduct the following types of business:

(1) accept foreign exchange deposits from individuals, legal entities or government agencies without the territory of Taiwan;
(2) accept foreign exchange deposits from financial institutions;
(3) raise capital on international financial markets;
(4) manage funds in international financial markets;
(5) engage in foreign currency trading and remittances;
(6) make loans to individuals, legal entities, government agencies or financial institutions;
(7) book and manage foreign currency loan-related liabilities.

PREFERENTIAL MEASURES

Taipei is in the same time zone as Hong Kong, Singapore and Manila. After the onset of the offshore bankine center here, all these centers will naturally compete with each other. To encourage international banks to come to Taipei to set up OBU branches, various kinds of preferential treatment and incentives in the areas of taxes and financial controls are granted in the Act.

For this purpose, the Act stipulates that offshore banking branches will not be subject to the restrictions prescribed under the "Foreign Exchange Control Act", "Interest Rate Regulations", "Banking Law" and "Organic Law of The Central Bank of China" and will be eligible for the following preferential treatment:

(1) Tax incentives

(a) Income of offshore banking branches will be exempt from the profit-seeking enterprise income tax, also known as business income tax (corporate income tax).
(b) Offshore banking branches will be exempt from business tax on their business receipts.
(c) All types of instruments used by offshore banking branches will be exempt from stamp duty.
(d) Offshore banking branches will not be required to withhold income tax on interest payable to their customers.

(2) Financial controls

(a) Offshore banking branch deposits will be exempt from the requirement of maintaining reserves with the Central Bank.
(b) Interest rates on deposits and loans of offshore banking branches will be determined by the offshore banking branches and their customers.
(c) Offshore banking branches will be exempt from the requirement of maintaining reserves for loan risks.

In addition, offshore banking branches may keep their business information confidential; they may bring in necessary telecommunication equipment and information systems, to be imported upon application on a case-by-case basis. All these measures are to cope with the special need of international banking operations.

However, the Act also made it clear that transactions between any individual, legal entity, government agency or financial institution within the territorial confines of Taiwan and any offshore banking branch shall be handled in accordance with the applicable laws and regulations governing transactions with foreign banks. It also stipulates that offshore banking branches handling foreign exchange deposits shall not (1) accept foreign currency in cash; (2) permit the withdrawal of foreign exchange deposits in New Taiwan Dollars. In other words, domestic and offshore markets are totally separated to ensure independence of domestic financial policies.

FUTURE PROSPECTS

In the later part of the 1970s, Taiwan gradually liberalized the conditions for foreign banks to set up their branches in that country. As a result, the number of foreign bank branches swelled with time. To date, there are 31 foreign branches and 7 representative offices . Upon the establishment of the offshore banking center, the basic members to participate in the operation will include these 38 foreign bank branches and representative offices and 12 domestic banks which have been licensed by the Central Bank to operate in foreign exchange. Also, the Government naturally welcomes other qualified international banks to join the group. As the Taipei Offshore Banking Center is situated in Far East Asia, its development will be closely linked to the economic development of the Asia-Pacific region. In the wake of the first oil crisis, the average economic growth rate of Southeast Asian countries was far above those of the rest of the world. On top of that, Southeast Asian countries have been endowed with abundant natural resources and manpower. It has been recognized as one of the regions in the world with high potential for industrial development.

With the expansion of trade and investment in the past, this region has accumulated immense convertible funds which international financial markets will be able to put to good use. On the other hand, capital required by potential investors in the region is expected to grow substantially with time. The Taipei Offshore Banking Center, together with other centers, will add to their financial capabilities, even more than at present, an amount estimated to be well over US$ 200 billion. They should be able to satisfy the development needs of all economies in the Asia-Pacific region.

Australian Resources Rent Tax

By D.C. Orrock

Mr. D.C. Orrock, B.Comm., F.C.A., A.C.I.S., is a partner of Charles J. Berg & Partners, Chartered Accountants, Sydney.

In 1977 the Australian Labour Party adopted a policy of a tax on natural resources, and since gaining office in March 1983, the Labour Government has publicized its intentions in this area. In December 1983 the Government released a Discussion Paper designed to form the basis of consultations with the mining sector and the various State Governments. Following such consultations it now appears that only offshore petroleum mining projects will be subject to the tax from 1 July 1984 while the taxing of onshore projects could be delayed by as much as 2 years. Although, initially, the tax is only to apply to the petroleum mining industry, it is intended that the tax will serve as a model for replacing the Commonwealth and State taxes presently levied on other parts of the mining sector.

PHILOSOPHY

The new tax, to be called the Resources Rent Tax (RRT), is to replace existing Commonwealth and State excises and royalties (i.e. excises on crude oil and liquified petroleum gas and royalties on both onshore and offshore petroleum production). The Government sees the introduction of this tax as necessary to remove the inherent problems associated with the existing taxation arrangements. The present arrangements were evolved over a period of time and involve both State and Commonwealth Governments. The new tax arrangements are aimed at providing not only encouragement for marginal projects, and therefore maximise petroleum extraction, but introducing long-term stability to the mining sector. Presently the excise on crude oil exempts production from oil fields discovered after 17 September 1975 and therefore acts as an incentive to oil exploration.

The Government considers that the nation's natural mineral resources are community property and, as such, the community is entitled to be rewarded for the depletion of those resources. This is particularly so where this activity produces exceptionally high returns on the investment in these industries. Australian Governments have believed that exploration for and extraction of these minerals is achieved more efficiently by allowing private organizations exclusive rights to explore or mine particular areas. The restriction associated with this policy (and those needed to produce efficient patterns of exploration and mine development) have produced profit levels well above those necessary to attract economically efficient levels of investment in such projects. Previous taxing arrangements have not taken into account the profitability of a project and therefore its capacity to pay. They have concentrated on the size of the operation, which acts as a disincentive to marginal producers. The RRT will be based on an individual project's capacity to pay and not the volume of its production.

STRUCTURE

The tax will apply to profits from petroleum mining which exceed a minimum or "threshold" level. Profitability will be determined from actual expenditures including items of both a current and a capital nature. Excess expenditure in any year will be carried forward to the following year at a "threshold rate". A deduction for interest and expenses in servicing capital will not be available in determining the tax base.

A project will be liable for RRT only when it has recouped its outlays together with the threshold rate of return compounded from year to year. Further net receipts will be liable for tax at the relevant tax rate. If in subsequent years expenditures exceed revenues, then these losses or capital expenditure will be treated in the same way and could result in the project temporarily ceasing to pay RRT until the threshold rate had been earned on these new expenditures.

The "threshold rate" aims at maintaining the value of future years' deductions until sufficient income is available. Where at the time of investment it is certain that any excess costs will eventually be written off in full, the threshold rate will correspond to the year-by-year cost of future recoupment of that certain value.

The existing crude oil levy will continue to apply to "old" (i.e. prior to 17 September 1975 fields) onshore and to existing offshore oil projects. New excise scale rates will apply to "new" onshore oil projects. The new rate scale incorporates higher threshold and lower excise rates.

The RRT proposals recently announced on 18 April 1984 are expected to net the Government an extra $ 300 million revenue in the next financial year. As from 1 July 1984 the RRT will apply to:

1. offshore oil projects which have not yet reached the development stage
2. "new" onshore oil projects.

This RRT tax will be levied on revenues before deduction of State royalties.

Generally the RRT tax rate will be 45% of relevant net revenue applying at a threshold rate equal to the long-term bond rate (approx. 15% p.a.) plus 10%. When the threshold increases to the total of the long-term bond rate plus 25%, the RRT tax rate increases to 60%.

Exploration expenditure incurred after 1 July 1984 will result in a taxable exploration subsidy of one-thrid.

[continued on p. 291]

THE 1984 INCOME TAX CHANGES IN THE REPUBLIC OF SOUTH AFRICA

By Dr. Erwin Spiro LL.D(h.c.)

The two main features of the income tax changes proposed by the Minister of Finance, Prof. Owen Horwood, who presented the 1984 Budget on 28 March 1984, are first an increase of the rate of the company tax and second the failure to make adjustments for the fiscal drag – complained of already in my report last year – by reason of which higher salaries and interest rates bring the taxpayer automatically into a higher bracket with a corresponding rise of the tax rate.

I. COMPANIES

Rate

Complaining about a steady downward tendency of income tax collections from companies, Prof. Horwood made the following remedial proposals:

(a) companies other than gold and diamond mining companies: the basic rate plus surcharge totalling 46.2% to be increased to a 50% basic rate with no surcharge;

(b) gold and diamond mining companies: the present 15% surcharge on the basic tax to be increased to 20%.

The new rates will apply in respect of years of assessment ending between 1 April 1984 and 31 March 1985.

Provisional tax

As companies should be able to make more accurate final estimates of current taxable income, the reference to taxable income for a preceding year will be eliminated so far as the final provisional tax payments of companies are concerned.

II. MATTERS AFFECTING TAXABLE INCOME

Incentives allowances in respect of machinery, plant and aircraft

As unrestricted expenditures of this kind have a distorting effect and militate against any efforts to spread the tax burden more evenly, the Minister proposed that, in the case of industrial machinery or plant, whether leased or purchased, brought into use between 1 April 1984 and 30 June 1985 (the expiring date of the investment allowance), the investment and initial allowances should be spread over two years, with two thirds being allowed in the first year and the remaining third in the second year. In view of the increased rate of company tax, the tax value of the allowances will even be enhanced.

Wear and tear allowance (finance charge)

The wear and tear allowance in respect of machinery or plant acquired on or after 15 March 1984 will be calculated on the cash cost only. Provision will, however, be made for a separate deduction of the finance charges when they are paid.

Valuation of trading stock

In 1976 the Income Tax Act was amended to allow traders to adopt the LIFO (last-in first-out) method of valuing trading stock whereby the last item of trading stock acquired by a trader is deemed to be the first item of such stock disposed of by him subsequently. The changeover led to the reduction of tax, not only in the year of changeover, but also in subsequent years, without it being clear whether there were other advantages over the conventional method of valuation. In view of the excessive loss of revenue as the result of the change-over, the concession will be withdrawn with effect from years of assessment ending on or after 1 April 1984. The advantages enjoyed by taxpayers using this method will not be immediately cancelled.

Training allowance

The effect of the training allowance under Section 11 *sept* of the Income Tax Act is that for every rand an employer spends on training he may deduct 2 rand from his taxable income. At the current company tax rate his liability is thereby reduced by 92.4 cents for each rand spent on training. The allowance has apparently been grossly abused, and it is for this reason that the Minister accepted the recommendations of the Standing Commission of Taxation Policy that the allowance should eventually be replaced by a cash allowance on a selective basis and that, as an interim measure, in respect of training expenses incurred on or after 1 September 1984, the existing allowance should be reduced from 100 to 50% of those expenses and the allowance should apply only to expenses incurred in respect of employees whose gross remuneration did not exceed 15,000 R per annum.

Fringe benefits

The Parliamentary Commission of Inquiry in regard to the Valuation of Fringe Benefits emphasized that the value of such benefits was always subject to tax and that the main purpose of the inquiry was to establish uniform rules for the determination of such values as well as to ensure equal treatment for all, regardless of status, standing or the nature of their offices or employment. The Commission also accepted that the cost to the employer should be the basis for the valuation of benefits in kind and that, with a view to cost-effectiveness, no value should be placed on certain less cost-effective benefits. Legislation to implement the Commission's recommendations with effect from 1 September 1984 will be incorporated in the Income Tax Bill.

Final deduction system

The following concessions will come into force in the new (1984-85) tax year:

Physically disabled persons. The limit of 2,400 R on the deduction of expenditure necessarily incurred by a taxpayer in respect of a physical disability suffered by himself, his wife or his child or stepchild will be increased to 3,000 R.

Medical expenses. The present ceiling of 2,000 R on the deduction of medical expenses incurred by a married person over 60 years of age will be increased to 3,000 R, and the corresponding limitation of 1,500 R in the case of an unmarried person over that age to 2,250 R. There will be no ceiling in respect of the deduction of such expenses where the taxpayer is over 70 years of age.

Pension fund contributions in respect of back-dated pensionable service. The present ceiling of 1,500 R on the deduction of such contributions will be increased to 1,800 R.

Contributions to a retirement annuity fund in respect of reinstatement of membership where the member had previously discontinued his contributions at present qualify for deduction from income, the annual deduction being limited to 1,500 R. This will be increased to 1,800 R.

An annuity payable by a taxpayer to a dependent of a former partner or employee of the taxpayer is deductible by the employer from his income up to an amount of 2,000 R per annum, which amount will be raised to 2,500 R.

III. RATES OF (NORMAL) INCOME TAX

Persons other than companies

Persons other than companies are in respect of the taxable income derived in the year of assessment ending 28 February 1985 or 30 June 1985, whichever is applicable, subject to (normal) income tax at the rates contained in the table attached, with a maximum basic marginal rate of 50% and with the *addition, in the case of unmarried persons, of a 20% surcharge on the tax.* The maximum rate of 50% is thus reached in the case of married persons where the taxable income exceeds 40,000 R and *in the case of unmarried persons where the taxable income* exceeds 28,000 R.

Companies

Companies are, in respect of taxable income derived in respect of every year of assessment ending during the 12-month period ending on 31 March 1985 subject to the following rates of (normal) income tax:

(i) on each rand of taxable income (excluding taxable income derived from mining operations and taxable income referred to in (ii) (c)), 50 cents;

(ii) in respect of taxable income derived from gold mining:
   (a) in the case of any mine other than a post-1966 gold mine, an amount determined in accordance with one of the formulae laid down plus a surcharge which is not payable in respect of certain assisted gold mines equal to 20% of the said amount;
   (b) in the case of post-1966 gold mines, an amount determined in accordance with one of the formulae laid down plus a surcharge of 20% of the said amount;
   (c) in the form of excess recoupments over capital expenditure accruing to companies which are or have been gold mining companies, the average rate of tax as determined in accordance with the Act or 35 cents per rand, whichever is higher;

(iii) in the case of companies mining for diamonds, 45 cents per rand of taxable income plus a surcharge of 20% of such amount;

(iv) in the case of companies mining, but not for gold or diamonds, the position is the same as in the case of a non-mining company (see (i) above).

IV. RATES OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

Non-resident shareholders' tax

The non-resident shareholders' tax is 15% of the amount of the dividend or interim dividend in question.

Undistributed profits tax

The undistributed profits tax is 33⅓ cents on every rand by which the "distributable income", as defined, exceeds the amount of dividends distributed during the "specified period", as defined.

Non-residents' tax on interest

The non-residents' tax on interest is 10% on the amount of the interest in question.

Donations tax

The donations tax is at progressive block rates, the block exceeding 90,000 R being taxable at the rate of 25%.

INCOME TAX TABLE REFERRED TO IN III ABOVE (for persons other than companies)

Taxable income (rand)	*Rates of tax (rand) + % on excess over lower figure*
Where the taxable income –	
does not exceed 8,000 *	12%
exceeds 8,000 but does not exceed 9,000	960 plus 14%
exceeds 9,000 but does not exceed 10,000	100 plus 16%
exceeds 10,000 but does not exceed 11,000	1,260 plus 18%
exceeds 11,000 but does not exceed 12,000	1,440 plus 20%
exceeds 12,000 but does not exceed 13,000	1,640 plus 22%
exceeds 13,000 but does not exceed 14,000	1,860 plus 24%
exceeds 14,000 but does not exceed 15,000	2,100 plus 26%
exceeds 15,000 but does not exceed 16,000	2,360 plus 28%
exceeds 16,000 but does not exceed 18,000	2,640 plus 30%
exceeds 18,000 but does not exceed 20,000	3,240 plus 32%
exceeds 20,000 but does not exceed 22,000	3,880 plus 34%
exceeds 22,000 but does not exceed 24,000	4,560 plus 36%
exceeds 24,000 but does not exceed 26,000	5,280 plus 38%
exceeds 26,000 but does not exceed 28,000	6,040 plus 40%
exceeds 28,000 but does not exceed 30,000	6,840 plus 42%
exceeds 30,000 but does not exceed 32,000	7,680 plus 44%
exceeds 32,000 but does not exceed 34,000	8,560 plus 46%
exceeds 34,000 but does not exceed 36,000	9,480 plus 47%
exceeds 36,000 but does not exceed 38,000	10,420 plus 48%
exceeds 38,000 but does not exceed 40,000	11,380 plus 49%
exceeds 40,000	12,360 plus 50%

* The Income Tax Act, 1983 (Act No. 94 of 1983) (see Section 61(1)) contains a provision extending the income limit under the final deduction system from 7,000 R to 8,00o R. The basic rate of tax was increased from 10% to 12% and a further rebate of 140 R was allowed.

SOUTH AFRICA:

Budget 1984-85

A Harsh Budget

Extracts from the Budget Speech pronounced by Mr. Owen Horwood, Minister of Finance, on 28 March 1984.

ADVERSE EXTRANEOUS DEVELOPMENTS

Since I introduced last year's Budget the economic situation in South Africa has been adversely affected by a number of largely unforeseen extraneous developments, over which we have no control. These developments have come to pose quite exceptional challenges to the authorities and have made the drawing up of this my tenth Budget exceedingly difficult and its contents crucially important. To meet the challenges confronting us, disciplined action is required. Today's Budget constitutes a vital part of the required policy response.

The first extraneous development that affected the South African economy adversely was the marked decline in the gold price. After reaching a peak of over $151 per ounce on 15 February 1983, the gold price averaged only $424 per ounce during 1983 as a whole and a mere $384 thus far in 1984.

A second unfavourable development was the sluggish recovery in world demand for those commodities which constitute South Africa's main exports other than gold. Our non-gold exports accordingly remained relatively low during most of 1983 and only began to show a rising tendency towards the close of the year and during the early months of 1984.

A third adverse development was the worsening of the drought. The welcome rains in many parts of the country during the fourth quarter of 1983 brought temporary relief, but subsequently the situation deteriorated again and assumed crisis proportions in several areas.

The combination of a declining gold price, sluggish non-gold exports and unfavourable weather conditions naturally had adverse effects on the real growth rate of the economy, the balance of payments and government revenue. In these circumstances the South African economy performed remarkably well. It is true that, comparing 1983 as a whole with 1982, real gross domestic product declined by about 3% and real gross domestic expenditure by about 4.5%. But it is now clear that the cyclical downswing which had commenced in September 1981 came to an end during the second quarter of 1983, and that the economy subsequently displayed a modest but meaningful recovery. This is borne out by the behaviour of real gross domestic expenditure, real gross domestic product, employment, imports and many other key indicators of economic activity, which all increased during the second half of 1983.

Welcome as this new upward tendency in the economy was, it did represent a deviation from the traditional pattern of the South African business cycle, and in a manner which called for careful policy adjustment. The upswing started out in much the usual fashion as an export-led recovery – in this case caused by the rise in the gold price between the middle of 1982 and February 1983, with all its concomitant expansionary monetary and other income-generating effects. But when the upward tendency of the gold price was sharply reversed after the middle of February 1983, the recovery in the economy was sustained by increases in government spending and private consumption. In the circumstances prevailing this meant that it was perhaps less solidly based and more likely to run into new balance of payments and other constraints. The changed nature of the upswing also had implications for fiscal and monetary policy, as I shall point out presently.

It follows that we shall have to wait for a marked improvement in the gold price and/or in the value of non-gold exports before the modest recovery to which I have referred can be expected to gain much further momentum. Although the gold price improved fitfully on occasion during the past month, it still remains relatively low. On the other hand, the economic recovery in the United States and, to a lesser extent, in Western Europe and Japan has during recent months begun to exert an expansionary effect on our non-gold exports. Present indications are that real gross domestic product will resume an upward tendency and achieve a positive rate of growth in the course of this year.

In saying this I realise, of course, the risks involved in economic forecasting. Laurence Peter said: "An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today."

Convincing progress has also been made during the past year in the battle against inflation. The twelve-month increase in the consumer price index was brought down from the 16.5% recorded as recently as May 1982, to 10% in February 1984. This was largely the result of the reduced rate of increase of aggregate spending and a lower rate of increase in import prices, reflecting both lower overseas inflation rates and the lagged effects of the appreciation of the rand between July 1982 and February 1983. Fiscal and monetary policy were important determinants of this significant decline in the inflation rate.

But for the fact that indirect taxes, and notably in this context GST, are included in the calculation of the consumer price index, the present inflation rate of 10% would undoubtedly be a single figure. There appears to be a good case for reviewing the components of the index in order to exclude taxes, as many countries do.

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WHY INCREASE OF SALES TAX

When I introduced last year's Budget I rejected any policy of deliberate reflation or stimulation of the economy. Instead, I underlined the need for a co-ordinated fiscal and monetary strategy to reduce the rate of inflation and to maintain a strong balance of payments. I stressed that the achievement of these two objectives was an essential precondition for rapid and sustainable economic growth in the medium and long term.

The March 1983 Budget was designed to fit into this strategy in three ways. Firstly, it provided for an increase in total expenditure of only R1,971 million or 10.3% above the revised estimate for 1982-'83, that is, for little if any increase in real terms. Secondly, the "deficit before borrowing" was estimated at the low magnitude of R2,082 million, or 2.4% of gross domestic product. Thirdly, provision was made to finance this expected deficit without net recourse to new money creation.

That this was the appropriate stance to adopt, has been clearly shown by subsequent events. However, our policy intentions were overtaken by the adverse extraneous developments I have outlined today, and, as I shall show presently, both government spending and the "deficit before borrowing" came to exceed the original Budget estimates. This outcome was mainly the result of increases in expenditure on drought relief, defence, food subsidies, salaries and wages, and interest on the public debt.

That these spending increases were essential and for the most part unavoidable in the national interest, is indisputable. But it must be recognised that they transformed a Budget that was meant, on balance, to be disinflationary into a moderately expansionary one.

In different circumstances there would have been much to be said for such a Budget "outturn", because of its contracyclical effect of stimulating demand and output at a time of relatively low economic activity. In the circumstances that actually prevailed, and particularly in view of the constraints imposed on the economy by the decline in the dollar price of gold and by the drought, the moderately expansionary effects of the Budget heightened the need for the Treasury and the Reserve Bank to control the money supply, to maintain a sound balance of payments and to reduce the rate of inflation. In the end, the authorities succeeded in making considerable progress towards their ultimate objectives. But the fact that the Budget "outturn" represented a deviation, in the sense explained above, from the strategy laid down in March 1983 clearly has implications for fiscal policy in the year ahead – a point to which I shall return.

It was in recognition of these changed circumstances that I increased the general sales tax from 6 to 7% with effect from 1 February 1984. This step has already served to reduce the budgetary deficit before borrowing and therefore also the need for the Treasury to approach the capital market for additional funds. But that is not the only salutary effect this fiscal measure has had. If the level of Government spending is taken as given, any increase in either direct or indirect taxation that has the effect of reducing the deficit before borrowing and the rate of increase of the money supply is in essence *disinflationary* in its effect on the economy.

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A TIME TO INCREASE TAXES

I now turn to the implications of the present economic situation for fiscal and monetary policy in the year ahead.

Despite the favourable results of our policies during the past two years, we have to face up to certain harsh realities. The dollar price of gold has declined further since the third quarter of 1983 and remains relatively low; the present drought is the worst in living memory in South Africa; the recovery of our non-gold exports has begun but, for the time being, remains sluggish. Inevitably, therefore, we have had to accept a temporary pause in the process of economic expansion. As most other countries have found in the recent past, there is no escape from this.

What, then has been South Africa's policy response to this situation and what should it be in the period ahead?

Basically, three broad policy options were open to us. The first was that of old-style deflation of the kind practised under the gold standard and, to a lesser extent, under the post-war gold-based Bretton Woods system of stable but adjustable exchange rates. This would have involved drastic cuts in government spending, substantial tax increases, tight control over the money supply and very high real rates of interest resulting in declining output, high levels of unemployment and general economic stagnation.

The second option, at the other end of the spectrum, was that of contra-cyclically stimulating the domestic economy by means of substantial increases in Government spending, tax reductions, lower interest rates and accelerated money creation through expansion of bank credit. This would initially have kept demand and output more buoyant, but would almost certainly have resulted in a marked deterioration of the balance of payments and a vicious circle of currency depreciation and inflation, as well as damage to South Africa's overseas credit rating. Eventually, domestic economic activity and growth would also have been adversely affected.

The third basic option was to steer a middle course between these two extremes by, on the one hand, permitting the exchange rate to depreciate moderately while, on the other, applying a conservative "mix" of fiscal and monetary policy, including high interest rates, with a view to curbing aggregate demand and total expenditure.

Of these three options, we chose the third one, that is the middle course, and I have already set out the results this strategy has achieved to date.

In the period ahead we shall continue to follow a conservative policy designed to maintain a sound balance of payments and to reduce the rate of inflation. We continue to attach great importance to the objectives of optimal and stable economic growth and a high and stable level of employment. But we remain convinced that the best, if not the only way to "go for growth" in the longer term is to give priority at this stage to maintaining balance of payments strength and curbing inflation.

To this end, we deem it important constantly to endeavour to improve the "mix" of fiscal and monetary policy. As I have pointed out, the deficit before borrowing in the Budget has risen above the level at which I should have liked it to be. It is true that over the 1983-'84 fiscal year as a whole, this deficit has been financed without new money creation. That is extremely important, but, as I shall indicate, there are limits to a financing policy of this kind.

To avoid an unduly large Budget deficit in present circumstances, there are only two courses of action that can be followed, either separately or jointly: the increase in government spending must be reduced and/or rates of taxation must be increased.

Oscar Wilde defined a pessimist as a man who when faced with a choice between two evils, chose *both*. But here there is no such clear-cut choice.

Curbing the increase in expenditure obviously has important economic advantages over substantial increases in taxation; and redoubled efforts have therefore been made to restrain government spending as much as possible. For reasons which I shall set out more fully later, however, provision has nevertheless had to be made for an increase in aggregate expenditure in the year ahead. This has left us with no option but to increase certain tax rates. Failure to do so would result in undertaxing and overborrowing and would represent downright bad budgeting.

As every responsible person knows, there is a time to cut tax rates and a time to increase them. On this occasion the interests of the country demand an increase in tax revenue. Given the expected increase in government spending for such essential purposes, among others, as education, defence, security, housing, food and transport subsidies, and drought relief, an increase in tax rates is necessary in order to prevent too great a reliance on borrowing.

In present circumstances the consequences of an unduly large deficit, that is, unduly large borrowing, would be damaging to the economy:

To begin with, it might mean that the Government was financing *current* expenditure by *borrowing*, that is, from capital, and that is something which ought to be avoided wherever possible.

Secondly, if the deficit is financed to any significant extent by new money creation, it would not only be highly inflationary but also put new downward pressure on the external value of the rand and lead to new balance of payments problems.

Thirdly, even if an unduly large deficit were to be financed through increased government stock issues on the capital market, it would raise interest rates and "crowd out" other deserving borrowers in both the public and the private sectors. This would exacerbate the plight of drought-stricken farmers, create problems for housing finance and retard the expected recovery in the economy.

To avoid making appropriate and, as it happens, relatively moderate tax adjustments now would therefore be asking for the trouble. We would simply be storing up problems for next year. In the end, the adjustments required would have to be much more drastic, disruptive and painful. We either have a policy of curbing inflation and maintaining a strong balance of payments, or we do not. *I believe today's Budget will demonstrate that the Government has both the will and the ability to deal effectively with the problems currently confronting the country and thus ensure, on a longer run view, the prosperity of what is basically a remarkably strong, versatile and resilient economy.*

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TAX COMMISSION

The Tax Commission has again been hard at work during the past year and has submitted a number of recommendations on a variety of matters, several of which have since been incorporated in legislation or otherwise implemented. Others are now being introduced or will be put into effect at a later stage. I am grateful to the Commission for keeping so watchful an eye over our tax structure and the anomalies that inevitably spring from it.

The Commission is at present engaged in a major exercise to reassess the advisability or otherwise of the separate taxation of married persons, and I hope to receive a report early next year. It is a complex matter – contrary to popular belief – and demands renewed study. In the meantime I must warn against any premature expectations that the fact of such an enquiry necessarily means a change in the present system. The matter will be dealt with entirely on its merits.

The Commission is also considering several other matters. There is an hiatus in our tax structure relating to the taxation of capital transfers and of socalled "unearned" income, such as capital profits on real estate and share transactions. I have asked the Commission to investigate the desirability and the practicability of taxing the gains made on such transactions, and to report to me as soon as they conveniently can.

According to Solon, that great lawgiver of antiquity, Laws are like spiders' webs: if some poor weak creature comes up against them it is caught, but a bigger one can break through and get away.

I think honourable members will be with me in wishing to ensure that this cannot be said of our tax structure.

NO FURTHER INCREASE OF SALES TAX

It may come as a relief to the House to know that I do not intend to propose any further increase in the 7% General Sales Tax as this tax was increased only recently. What I do propose, however, is to request the Standing Commission to advise me on two matters affecting this tax source:

(a) the extent to which it may be desirable and practicable for a limited number of basic good items or, alternatively, *all* foods to be excluded from GST or be taxed at al lower rate, and also to advise on the resultant loss of revenue as well as the administrative problems that would arise; and
(b) the extent to which this tax should be extended to services presently untaxed, such as professional services.

REVENUE 1983-84

Aggregate revenue for the 1983-'84 financial year is now estimated at R19,048m, which is marginally lower than the printed estimate of R19,107m. Inland Revenue sources contributed R17,155m of this amount and exceeded the original estimate by R118m or less than 1%. Collections, by Customs and Excise at R1,893m are 8.1% lower than budgeted.

Relatively large variations are discernible between the latest and the original estimates of the various sources of income. The volatility of the gold price and its relatively high livel in rand terms during the first half of the 1983-'84 financial year are clearly reflected in the tax and lease payments received from gold mines, currently estimated at R2,237m or 23.6% above the original estimate.

The 8.7% increase in personal income tax to R5,750m is mainly the result of increased remuneration coupled with fiscal drag. Furthermore, the exceptional buoyancy in the real estate market is manifested in an increase of no less than 72.2% in the revised estimate for transfer duties, now calculated to have netted some R310m.

In spite of the increase of 1% in general sales tax during February 1984, the present estimate for 1983-'84 from that source is R3,850m, or 2.7% shy of the original estimate. This clearly reflects the contractionary phase of the South African economy. Company tax, for example, amounted to only R3,225m or 21.3% less than the original estimate. Certain malpractices, to which I shall return, contributed to this outcome.

The decrease in customs and excise receipts is attributable partly to the phasing out of the surcharge on imports by December 1983. Payments in respect of the Customs Union, plus SWA, which are shown as a so-called drawback of revenue, are estimated at R1,157m or 15.7% higher than the original estimate.

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REVENUE 1984-85

On the current basis of taxation, revenue for the 1984-'85 financial year is estimated at R20,761 million, an increase of 9% on the revised estimate for 1983-'84. Of this amount Inland Revenue will contribute some 92% or R19,125 million, which is 11.5% more than this year. The downward trend in respect of customs and excise will continue: we expect a 13.6% decline on the 1983-'84 estimate, to a net amount of R136 million.

Of Inland Revenue sources, only personal income tax and general sales tax expected to show meaningful improvements: to a net R7,265 million for personal income tax and to a net R5,010 million for general sales tax, which are increases of 26.3% and 30.1% respectively on the revised 1983-'84 figures.

Company tax revenue will again mirror the unfavourable economic milieu. The estimate of R2,900 million is 10.1% down on revised 1983-'84. The lower gold price lies behind an anticipated 20.2% decline in revenue from gold mines, to R1,786 million.

Although customs duties are expected to increase by 7% to R1,125 million and excise duties by 4.4% to R1,770 million, this is more than offset by the loss of income from the import surcharge. Moreover, formula disbursements in respect of the Customs Union and South-West Africa are expected to rise again next year, the estimated R1,339 million representing an increase of 15.7% on revised 1983-'84.

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CUSTOMS AND EXCISE

Beer

Beer remains a growth industry even in today's difficult times and I feel that the producer can bear an increased tax. I therefore propose that the duty on all malt beers, excluding sorghum beers, both imported and local, be increased by 2.4 cents per litre or about 0.9 cents per container of 375 millilitres (or per pint according to Imperial measures). The retail price of beer should not rise by more than one cent per container of 375 millilitres and I shall expect the trade to give due consideration to the interests of the consumer. The estimated additional revenue amounts to approximately R29 million next year.

Wine

Sections of the wine industry in the Western Cape have been experiencing financial problems for some time and I therefore do not feel it equitable to impose or raise excise duties on wines and spirits at this time. The Board of Trade and Industries is at present investigating the position of brandy with a view to assisting the industry, possibly by increasing the rebate on blended brandy to the full GATT binding. No decision on the matter can be taken until their report has been submitted and studied, among others by the Commissioner for Customs and Excise.

Petroleum products

At present four cents of the customs or excise duty on a litre of petrol, distillate fuel (diesel) or residual fuel oil is paid into the State Oil Fund, and this has been utilised mainly for the financing of Sasol Two and Sasol Three. As the need for further financing is now diminishing, the Government had decided that, at least for 1984-'85, only two cents of this amount should be paid over to the State Oil fund. The remaining two cents will accrue to the Exchequer.

It has further been decided that an additional amount of one cent of the customs or excise duty in respect of certain diesel or residual fuel oil at present paying the middle tariff and which has to be deposited in the State Oil Fund will also go to the Exchequer.

The revenue thus obtained amounts to R163 million and will assist in financing the deficit but of course will have no price effect as it is simply a diversion of revenue from the State Oil Fund to the Exchequer.

Tobacco

Although the tobacco industry is not in a growth phase at present, I feel that due to pressing financing needs a contribution should be made by smokers too. I therefore propose that the customs and excise duties on cigarettes be increased by one cent per 10 cigarettes and on cigarette tobacco by one cent per 50 grammes. The duties on pipe tobacco and cigars will not change. The additional revenue for 1984-'85 is estimated at R33 million.

Ad Valorem Excise Duties and Ad Valorem Customs Duties:

In the present circumstances it is furthermore fair to expect a tax contribution from buyers of non-essential goods and I therefore propose that the existing ad valorem customs and excise duties on imported and locally manufactured goods of the same class or kind be increased by 5%, that is 25% ad valorem duties become 30% and 30% ad valorem duties become 35%.

Although the nominal rates of duty seem high, the effective rates are much lower as these duties are assessed at the point of importation or manufacture on so-called neutral values, which are much lower than the actual selling prices. For example, a 35% duty on a television set retailing at about R900 but with a neutral value of R360 is equivalent to only 14% of the retail price. This means that the 5% increase now proposed should not add more than about 2% to the retail price.

The revenue from this source during 1984-'85 is estimated at R41 million.

Motor vehicles

While ad valorem duties are under consideration it is also appropriate to review the contribution to the Exchequer by the motor industry. Notwithstanding recessionary conditions in the economy, the turnover in the motor industry has been satisfactory and I feel that buyers of new vehicles can afford to make a larger contribution to the State's coffers.

I therefore propose that ad valorem excise duties and ad valorem customs duties of 1% or 2%, as the case may be, be imposed on motor vehicles as set out in the taxation proposals. Basically this means that motor cars below a neutral value of R11,500 (which corresponds with a retail value of approximately R15,000), as well as heavy vehicles, combi's and mini buses, will be taxed an additional 1% on their neutral value; the remainder, that is higher priced motor cars, will bear a

2% ad valorem duty. Because neutral value is considerably below retail value, retail prices should rise by less than 1% and 2%, respectively. Agricultural tractors are exempted.

The revenue for 1984-'85 from this source is estimated at R37 million.

All the increases in customs and excise duties take effect immediately and apply to all goods that have not yet been cleared for home consumption, that is, goods not yet removed from the storage warehouses and premises of manufacturers licensed with the Commissioner for Customs and Excise.

In terms of section 58(1) of the Customs and Excise Act, No. 91 of 1964, I now lay upon the Table for consideration by the House the formal taxation proposals with regard to customs and excise duties.

Since all the increased duties are levied at the point of import or manufacture, there is no justification for merchants to increase the prices of goods inventoried at the old rates of duty. I therefore rely on such merchants to adjust their prices only when new stocks are sold. Consumers should expect and insist that the retail prices of all goods affected by these proposals should not be raised by more than the increased duties and that no exploitation takes place. I am counting on the co-operation of the trade.

The increased customs and excise duties proposed should in total yield R303 million in 1984-'85, but to this must be added a further R10 million to be collected in the form of consequential general sales tax on all items carrying the higher duties.

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Company tax

Income tax collections from companies have shown a steady downward tendency. Analyses of published company reports indicate that there are many profitable companies paying very little tax or even no tax at all. These comparisons are not always valid inasmuch as the Income Tax Act provides for the taxation of taxable income, which is not necessarily the same as profit. Various incentive allowances, which do not figure in a company's balance sheet, have contributed to this state of affairs.

This is not in itself a cause for criticism, as the allowances are legitimately claimed. However, periodic appropriate measures are essential to arrest any increasing erosion of the tax base and a review of the company rate has thus become imperative.

My proposals in this regard are the following:
(a) Companies other than gold and diamond mining companies: I propose that the basic rate plus surcharge totaling 46.2% be increased to a 50% basic rate with no surcharge. The additional revenue for the 1984-'85 financial year is estimated at R203 million.

(b) Gold and diamond mining companies: I propose to increase the present 15% surcharge on basic tax to 20%. The additional revenue for the 1984-'85 financial year is estimated at R59 million.

The new rates will apply in respect of years of assessment ending between April 1, 1984 and March 31, 1985.

SMALL COMPANIES

The taxation of the income of small closely-held companies and of their shareholders is receiving the attention of my Department. I am asking the Standing Commission on Taxation Policy to look into this matter urgently, insofar as there should ideally be neutrality of treatment as between different forms of enterprise. It will be appreciated that the administration of any scheme to achieve this should be as simple as possible. I hope that the necessary legislative provisions can be included in this year's Income Tax Bill.

DETERMINATION OF TAXABLE INCOME

There are a few additional proposals affecting the determination of taxable income with which I should like to deal at this point. These refer to incentive allowances, wear and tear allowances, valuation of trading stock and the payment of provisional tax.

(a) *Incentive allowances in respect of machinery, plant and aircraft*

In recent years the selling of tax bases for the purposes of taking advantage of the concession involving incentive allowances to lessors has gained momentum. A number of commercial firms – an I may add individuals – have entered this field, and the drain on revenue has become alarming. In this regard I am reminded irresistibly of some lines by Lewis Carrol:

He thought he saw a Banker's Clerk
Discending from the bus;
He looked again, and found it was
A Hippopotamus.
"If this should stay to dine", he said,
"There won't be much for us."

I need hardly state that unrestricted tax expenditures of this kind have a distorting effect and militate against any efforts to spread the tax burden more evenly.

On March 14, 1984 I announced that losses in respect of agreements of lease concluded on or after March 15, 1984 would no longer be allowed for set-off against income derived otherwise than from the leasing of movables. The allowances in respect of agreeements concluded before March 15, 1984 are not affected by the announcement.

The difficult position of the Exchequer this coming year obliges me to propose a further adjustment. Normally the investment and intial allowances in respect of machinery or plant would be granted in full in the year in which the machinery or plant is brought into use. The impact on State revenue collections of allowances granted in this way over the next 15 months would be abnormally high and would have a serious effect on revenue collections.

I therefore propose that, in the case of industrial machinery or plant, whether leased or purchased, which is brought into use between April 1, 1984 and June 30, 1985 (the date on which the investment allowance expires), the investment and initial allowances be spread over two years, with two-thirds being allowed in the first year and the remaining third in the second year.

The quantum of the allowances will not be diminished. In fact, by reason of the increased rate of company tax, the tax value of the allowances will even be enhanced. Although extra taxation revenue will be received in the first year, this should by reason of the relief in the second year not be seen as being other than an advance payment of tax.

The value of the allowances has increased whenever the rate of tax has been increased, and one could reason that there is justification for reducing the rates of allowances to ensure that the State's contribution via the tax sacrifice should not rise, but I do not wish to propose any such adjustment at this stage. The quantum of the initial allowance in respect of machinery or plant brought into use on or after 1 July 1985 will, nevertheless, have to bereviewed in the light of our revenue needs and the change in company tax rates.

The expected increase in revenue during the 1984-'85 financial year in consequence of these changes is estimated at R285 million.

(b) *Wear and tear allowance*

The value of an asset on which the wear and tear allowance may be claimed under the Income Tax Act can in certain cases, particularly where the asset is acquired under a hire purchase transaction, include finance charges. This practice is based on an old decision of the Income Tax Special Court.

It has become apparent, however, that the values of such assets are being inflated in an undesirable manner by the addition of finance charges not yet incurred. I accordingly announced in my press release of 14 March 1984 that the wear and tear allowance in respect of machinery or plant acquired on or after 15 March 1984 would be calculated on the cash cost only. Provision will be made for a separate deduction of the finance charges when they are paid.

(c) *Valuation of trading stock*

In 1976 the Income Tax Act was amended so as to allow traders to adopt the LIFO (last-in-first-out) method of valuing trading stock. Under this method the last item of trading stock of any class acquired by a trader is deemed to be the first item of such stock disposed of by him subsequently.

In practice the change to the LIFO method results in a considerable reduction of tax in the year of changeover, and in a lesser reduction in subsequent years. Traders are thereby tempted to make the change primarily or solely for taxation reasons.

I am not convinced of the advantages of LIFO over the conventional method of valuation. The loss of revenue caused is excessive, and I propose to introduce an amendment to the Income Tax Act withdrawing the concession with effect from years of assessment ending on or after 1 April 1984. The withdrawal of the concession will however be effected in such a manner as not to result in the immediate cancellation of the advantages enjoyed by taxpayers using this method.

(d) *Provisional tax*

At present a provisional taxpayer is entitled to estimate his taxable income at an amount equal to the lesser of 90% of his actual taxable income for the year of assessment or the amount of his taxable income for the latest preceding year for which he has received a tax assessment. This is advantageous to the taxpayer whose taxable income for the preceding year was low, as he may thereby postpone payment of a portion of his current year's tax until he is assessed.

The necessity for this rule is apparent in the case of individual taxpayers. However, I consider that companies should be able to make more accurate final estimates of current taxable income and I propose accordingly to introduce an amendment to the Income Tax Act to eliminate, so far as the final provisional tax payments of companies are concerned, the reference to the taxable income for a preceding year.

The net additional revenue expected from adjustments to wear and tear allowances, from valuation of trading stock and from provisional tax payments is R30 million for 1984-'85.

I should like to add a closing remark with regard to these various tax incentives. As Longenhoven puts it in his homely way:

"Gooi vir jou gas sigorei by die koffie en hy sal die sigorei onthou en die koffie vergeet."

I am sure however that *our* cup of coffee, although now somewhat diluted, will still be very welcome to the thirsty!

It is now time to turn to a further proposal and one affecting the company and the individual alike.

STAMP DUTY ON BANKING TRANSACTIONS

During the past few years credit cards have increasingly replaced cheques as a method of payment for individuals, and I feel the time has arrived to adjust to these structural developments in the settlement of accounts and transfers of money. I therefore wish to propose that the present stamp duty of 5 cents per cheque be abolished and be replaced by a stamp duty on debit banking entries (including credit card transactions and automatic teller operations) relating to payments for goods and services, transfers of money to third parties and cash withdrawals. The charge will be 5 cents per debt. Savings accounts with banks, building societies and the Post Offices will not be subject to the charge.

To enable the banks to make the necessary administrative arrangements it is proposed that the new charge will not come into operation until 1 July 1984.

The additional revenue from this source for 1984-'85 is estimated at R15 million.

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INDIVIDUAL INCOME tAX

Uniform tax system

I am grateful to all concerned for the smooth way in which employers and employees alike have switched over from the old system of taxation to the new uniform system where all people working side by side in the development of our country, including citizens of the six National States, are to be taxed in trems of the same Act. This is probably due to the realization that the majority of taxpayers affected will now be paying less tax than before, but much credit is also due to employers, to organized commerce and industry, and to employee organizations for explaining the implications of the new system to all concerned. Furthermore, I believe the information and assistance provided by Inland Revenue officials over a long period were crucial in ensuring the success of this exercise. I should like to convey the Government's sincere appreciation to all concerned.

Fringe benefits

St. Augustine tells us that as a young man he used to pray for chastity – but not just yet! This rather puts me in mind of the taxation of fringe benefits, the *principle* of which has been widely accepted in this country for many years but the uniform practical application of which has run into considerable difficulties.

I announced earlier this year that the Government had accepted the recommendations contained in the Report of the Parliamentary Commission of Inquiry in regard to the Valuation of Fringe Benefits, which I am tabling today. The Commission has emphasized that the value of such benefits has always been subject to tax and that the main purpose of its inquiry was to establish uniform rules for the determination of such values as well as to ensure equal treatment for all regardless of status, standing, or the nature of their offices or employment.

The Commission has also accepted that the cost to the employer should be the basis for the valuation of benefits in kind and that, with a view to cost-effectiveness, no value should be placed on certain less cost-effective benefits.

Legislation to implement the Commission's recommendations with effect from 1 September 1984 will be incorporated in the Income Tax Bill, which is to be considered later during this Session. As promised, organised commerce, industry and labour will be afforded the opportunity to comment on the practical application of the draft provisions, before the Bill is finally drafted.

As the provisions will come into effect halfway through the 1984-'85 tax year, it will be necessary to modify the proposal of the Commission with regard to the phasing in of the taxation on certain benefits.

It is expected that the introduction of the tax on fringe benefits as here referred to will yield an additional R50 million for 1984-'85.

Personal income tax vs. company tax

In drawing up the Budget for the impending financial year I set out to avoid, if at all possible, the need to raise the general sales tax and personal income tax rates. I am glad I have succeeded in both these objectives.

I am glad also that I have been able to equalise the maximum marginal personal income tax rate and the company tax rate at 50%, thus eliminating several anomalies and bringing us a step closer to tax neutrality between these major forms of taxation.

Final deduction system

A substantial concession has been made to many individuals through the final deduction system.

The Income Tax Act, 1983, contains a provision extending the income limit under the final deduction system from R7,000 to R8,000. The basic rate of tax was increased from 10% to 12% and a further rebate of R140 was allowed. The effect of these provisions was to increase the thresholds at which tax liability commences, for example, for an unmarried taxpayer to R3,575, for a married taxpayer with no children to R4,384, and for a married taxpayer with three children to R6,883.

The estimated loss of revenue during 1984-'85 as a result of this concession is R26 million. This amount has already been allowed for in the printed Estimate of Revenue tabled today.

I should like to announce a measure of further tax relief, this time to the disabled, our senior citizens and those who build up retirement benefits. These concessions will come into force in the new (1984-'85) tax year.

Physically disabled persons: I propose that the limit of R2,400 on the deduction of expenditure necessarily incurred by a taxpayer in respect of a physical disability suffered by himself, his wife or his child or stepchild be increased to R3,000.

Medical expenses: I propose that the present ceiling of R2,000 on the deduction of medical expenses incurred by a married person over 60 be increased to R3,000 and that the corresponding limitation of R1,500 in the case of an unmarried person over that age be increased to R2,250. Furthermore, there should be no ceiling in respect of the deduction of such expenses where the taxpayer is over 70 years of age.

Pension fund contributions in respect of backdated pensionable service: I propose that the present ceiling of R1,500 on the deduction of such contributions be increased to R1,800.

Contributions to a retirement annuity fund in respect of reinstatement of membership where the member had previously discontinued his contributions at present qualify for deduction from income, the annual deduction being limited to R1,500. I propose that this be increased to R1,800.

An annuity payable by a taxpayer to a dependent of a former partner or employee of the taxpayer is deductible by the employer from his income up to an amount of R2,000 per annum. I propose that this be raised to R2,500.

The sacrifice of revenue entailed by these concessions is estimated at R4 million for 1984-'85. Taking into account the concession of R26 million in respect of the Final Deduction System referred to earlier and already allowed for, the value of the tax concessions in the Budget amounts to R30 million.

BOTSWANA:

1984 Budget Speech

By Bernadette P. Davey

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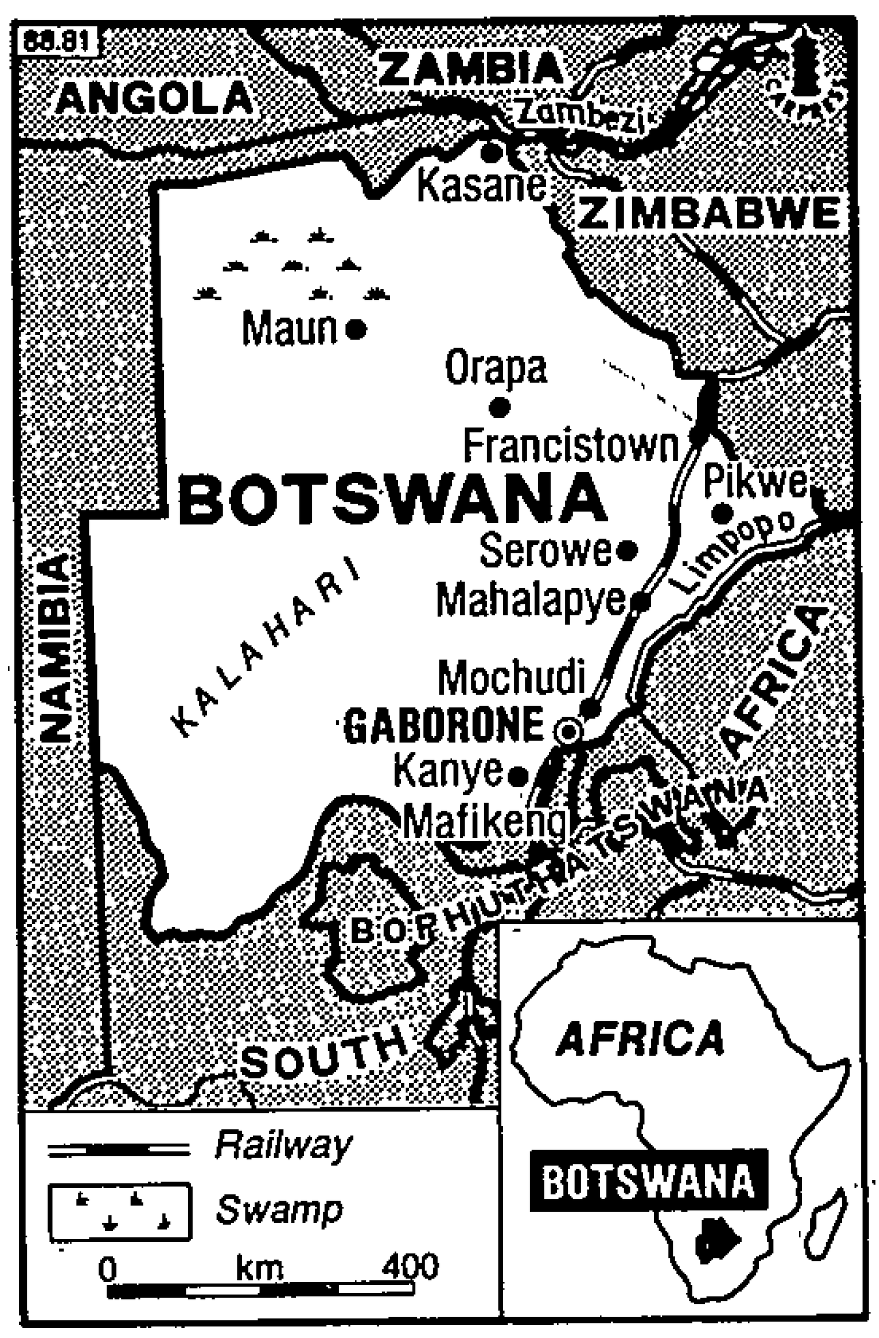

On 13 February 1984, the Minister of Finance and Development Planning, His Honour, P.S. Mmusi, delivered the 1984 Budget Speech to the National Assembly. In an atmosphere of cautious optimism, the Government re-emphasized the main thrust of its economic viewpoint to maintain sound fiscal and monetary policies consistent with the level of development in Botswana and other Government policies to promote economic development in both the private and parastatal sectors.[1]

Botswana's economic record during the preceding year has contributed to the more optimistic climate together with the underlying signs of recovery from the recession in the industrialized countries. The balance of payments showed remarkable improvement during 1983, achieving a record external payments surplus.[2] The first ever merchandise trade surplus in Botswana was also achieved. Much of the improvement in the economy was due to increased diamond revenues and the balance of payments also benefitted from the sluggish growth in demand for imports.

On the other hand, two consecutive years of drought have led to a decline in real agricultural output. The Minister advised that current indications show that another bad harvest is expected. The mineral sector has been hit to some extent by depressed world prices. However, it was pointed out that it continues to be Government policy to promote exploration and exploitation of mineral resources whenever potentially economically viable projects are identified.

The Minister highlighted 5 areas which would receive priority funding.[3] These are the expansion of the education sector, particularly technical and vocational education; the Financial Assistance Policy; the Rural and Urban Authority Deficit Grants; maintenance, especially of the road system; and the operation and maintenance of an increased number of water supply systems.

Against this general economic background and with the intention of aiming towards fiscal reform and a more equitable system of taxation, the main proposals announced by the Minister are:

DEATH DUTIES

The Minister announced that he would be re-introducing to the House the Death Duties (Repeal) Bill (No. 21 of 1983) and the Capital Transfer Tax Bill (No. 19 of 1983) which had been deferred the previous year following representations in the house of Chiefs. Mr. Mmusi stated that he had carefully considered these views but had concluded that the proposals remained sound and equitable and in the interests of the nation as a whole. The Bills were then once again presented to the House for consideration.

INCOME TAX

A reduction in the burden of income tax on persons other than companies was announced. This is to be achieved by a slight lowering of the rates, together with a widening of the rate bands at higher levels of income. It is also proposed to increase personal allowances.[4] The insurance allowance will be raised to 1,200 P and the education allowance to 900 P.

TAX EVASION AND AVOIDANCE

The Minister of Finance pointed out that "with the growth and sophistication of our economy, tax evasion in the business sector is becoming a problem".[5] Thus, the Minister observed that it was not equitable when employees paid the correct tax through the PAYE system and some companies were paying less than they ought. It was announced that an Investigation and Intelligence Branch within the Department of Taxes had already been established and that it would be fully operational during the course of this year.

On a similar theme, it is proposed to strengthen the Tax Commissioner's powers relating to tax avoidance. Such powers will mostly concern transactions between private companies and their shareholders. This has been interpreted as an amplification of the existing provisions of S. 35 of the Income Tax Act with reference to the con-

We would like to express our gratitude to Dr. P. Takirambudde, Head of Law Department, University of Botswana and Rapporteur for the International Bureau of Fiscal Documentation, who provided us with the text of the Budget Speech.

1. Paragraph 66, 1984 Budget Speech by His Honour, P.S. Mmusi, The Vice-President and Minister of Finance and Development Planning, delivered to the National Assembly on 13 February 1984. Printed by the Government Printer, Gaborone.
2. Paragraph 11 of the Budget Speech. The 1983 surplus amounted to 133 million P compared with a surplus of 57 milion P in 1982 and a deficit of 61 million P in 1981.
3. Paragraph 58 of the Budget Speech.
4. In paragraph 126 of the Budget Speech, the Minister gave the example of a married person whose tax rate was 5% and who paid 50 P for the tax year 1983/84 and would now pay an annual tax of 30 P, a reduction of 40%. At the other end of the scale, a married person whose highest tax rate was 27.5% and who paid 2,050 P would now pay 1,750 P, a reduction of 300 P or 14.6%.
5. Paragraph 129 of the Budget Speech.

cept of transactions which are not carried out at arm's length. It is also intended to introduce provisions to deal with the problem of under-capitalization of private companies. One proposed measure is to exempt bonus shares from income tax and another is to treat interest on loans from shareholders as if they were part of taxable profits. The Minister of Finance observed that the present deductibility of interest in arriving at chargeable income not only encourages unduly the use of excessive loans with nominal equity capital but also "deprives the fisc of a fair share of profits of business enterprises, particularly those which are owned by non-residents".[6]

STATUS OF WOMEN

After representations from married women and from working women generally as regards their status under income tax legislation, the Minister announced the following proposals. A married woman will be able to elect to be assessed in her own name separately from the husband, or, if the married couple so elects, for the wife to be the taxpayer instead of the husband. This measure is not designed in any way to reduce the amount of tax paid by a family unit but is solely designed to improve the position of women. In addition, the possibility of treating day nurseries as educational establishments for the purpose of granting educational allowances so as to help working women with young children is to be investigated.

INDIRECT TAXATION

In connection with indirect taxes the Minister only announced a few minor alterations to the Sales Tax Act. Sales tax on diesel is to be abolished and that levied on alcoholic beverages is to be reduced by 20%. However, the scope of the sales tax is to be extended to include cider and other brands of alcoholic beverages.

CONCLUSION

From a general viewpoint, the Minister is continuing to further reform the tax system to make it more broad-based and equitable. A substantial degree of reform has already been achieved. Perhaps most importantly, the Minister sought to adhere to the general philosophy held by the Government. Such a policy was summed up as:

> Government strategy is to chart a development course consistent with the best allocation of the nation's growing supply of skilled manpower, to build up foreign exchange reserves and Government revenues in good years and to stick to our steady development course in bad years by running down the reserves accumulated in good years.[7]

As it would appear that such a strategy has already contributed positively to the economy, it is to be hoped that such a policy will augur well for the future.

6. paragraph 130 of the Budget Speech.
7. Paragraph 52 of the Budget Speech.

BOTSWANA:

1984 Budget Speech

Extracts from the Budget Speech pronounced on 13 February 1984 by His Honour, P.S. Mmusi, Minister of Finance and Development Planning.

. . .

125. Mr. Speaker, I now come to the subject of direct taxation. Honourable Members will recall that in my budget speeches for 1982/83 and 1983/84 I referred to the need for a more broadbased and equitable tax system. A substantial part of the reforms which I had intended to achieve has now been accomplished. One of my proposals last year was to introduce a very mild Capital Transfer Tax to be administered by the Department of Taxes, and to abolish the Death Duties Act. However, in order to allow time for consultation with the House of Chiefs, I postponed presentation of the two Bills before this House, although they had already been published.

I am sure Honourable Members are broadly aware of the sentiments expressed in that House regarding the proposed change. I have given their views the most careful consideration, but remain convinced that my proposals are both sound and equitable and in the interests of the nation as a whole. We continue to borrow extensively from abroad and receive sizeable amounts in grants and aid from friendly countries, who themselves tax their subjects heavily over a wide variety of sources. Over the last two years there has been a discernible decline in foreign aid receipts and this points to a greater reliance on our own resourcefulness. I therefore propose to present the two Bills to this House during the course of this meeting.

126. Mr. Speaker, I propose to reduce further the burden of the Income Tax by lowering the rates slightly, by widening the rate bands at higher levels of income and by increasing the personal allowance. Examples of the effects of these changes are:

(i) a married person whose tax rate was 5% and who paid P50 for the tax year 1983/84 will now pay an annual tax of P30, a reduction of 40%;
(ii) a married person whose highest tax rate was 10% and who paid tax of P250 will now pay tax of P210, a reduction of 16%;
(iii) a married person whose highest tax rate was 27.5% and who paid tax of P2050 will now pay P1750 – a reduction of P300, or 14.6%.

I have also increased the insurance and the education allowances to P1,2000 and P900 respectively.

127. In arriving at these changes, care has been taken to maintain the equity and progressivity of the tax. I decided to scale down the rate of tax instead of substantially increasing existing personal allowances, as some had argued, because the latter increase would have unduly distorted the progressivity of our tax structure. For similar reasons I have also resisted requests for the introduction of new allowances.

128. The national loss of revenue for the financial year 1984/85 that will be incurred as a result of these proposals will be in the region of P3.5 million, but I expect the total tax revenue for the year to be higher than in 1983/84.

129. With the growth and increased sophistication of our economy, tax evasion in the business sector is becoming a problem. Accordingly I shall take steps to ensure that the tax laws are respected and properly enforced. it is unfair that while employees pay their correct tax by way of PAYE deduction, adjusted at year-end by assessment, some companies are paying less tax than they ought to be paying. The final result of this unsatisfactory state of affairs is a higher total tax yield from the employment sector than from the non-mineral business sector. In keeping with my

policy to improve tax administration, I have already established an Investigation and Intelligence branch within the Department of Taxes. It is functioning well and I expect it to become fully operational during the course of this year.

130. I am also proposing to strengthen the Commissioner's powers relating to tax avoidance through the Income Tax (Amendment) Bill which I shall present to this House during this session. Much of this legislation will be concerned with transactions between private companies and their shareholders. It will also attempt to deal with the problem of undercapitalisation of these companies, in so far as it is possible or desirable to do so through the tax system. One of the measures I shall propose is to exempt bonus shares from income tax. I trust that this measure will encourage companies to capitalise profits for expansion. Another measure aimed at encouraging proper capitalization is the proposed treatment of interest on loans from shareholders as if they were a part of taxable profits. The present deductibility of interest in arriving at chargeable income not only encourages unduly the use of excessive loans with nominal equity capital, but also deprives the fisc of a fair share of profits of business enterprises, particularly those which are owned by non-residents.

131. Mr. Speaker, the Department of Taxes has been bedevilled by staffing problems during the last three years. Steps are being taken to recruit suitable staff by individual selection and through bi-lateral aid. At the same time, we have obtained CFTC technical assistance to undertake on-the-desk-training of local staff at Inspector level, so that our localisation policy will be truly effective. I am anxious that the Income Tax Department should function smoothly and to that end I am proposing certain changes in the procedural and collection provisions of the Income Tax Act. It is my hope and expectation that these improvements will lead to better compliance from taxpayers and more effective public relations and enforcement by the tax administration.

132. Mr. Speaker, I have received representations from married women regarding their status under the Income Tax Act and from working women generally with regard to certain tax problems which confront working women with young children. I have examined these representations with a great deal of sympathy. I regret there has not been time to include the desired changes in the forthcoming Amendment Bill, but I shall make every effort to ensure that the necessary amendments are presented to this House in due course. I shall endeavour to provide that a married woman may either elect to be assessed in her own name separately from the husband, or, if the married couple so elects, for the wife to be the taxpayer instead of the husband. I must point out that this measure is solely designed to improve the status of women, and that there will be no reduction in tax payable by family unit. I shall also investigate the possibility of treating day nurseries as educational establishments for the purpose of granting educational allowances so as to help working women with young children.

133. Mr. Speaker, as regards indirect taxation, I do not propose to make any radical changes in the Sales Tax Act. I have considered representations from sectional interests for some tax relief but I am obliged to consider the very high administrative cost of granting selective concessions. On the basis of past experience selective concessions invariably lead to malpractices and such a situation is not justified, on the grounds of equity. Our immediate neighbours impose Sales Taxes which are far more onerous than our highly selective, single-stage Sales Tax. I am unconvinced that the tax penalises any one section of the community to any greater or lesser extent than it does others. However, I am abolishing Sales Tax on diesel and reducing that on alcoholic beverages by 20%, and trust this will to some extent accommodate these sectional concerns. At the same time I propose to extend the ambit of Sales Tax to include cider and other brands of alcoholic beverages. The reductions, particularly that on fuel, will help to reduce inflation.

134. Mr. Speaker, that concludes my address on the budget for 1984/85. I would welcome comments by the Honourable Members on my proposals, and on the policies I have outlined as appropriate under these circumstances. I therefore move that the Appropriation (1984/85) Bill be read a second time.

Forthcoming Budgets 1984 in Africa (from June 1984 onwards)

JUNE	Cameroon, Congo, Gabon, Kenya*, Mauritius, Sudan, Tanzania, Uganda
JULY	Gambia, Liberia, Sierra Leone*, Zimbabwe*
AUGUST	–
SEPTEMBER	–
NOVEMBER	Niger
DECEMBER	Ivory Coast*, Madagascar, Senegal, Zaire*

* African countries where the possibility might arise to report developments in the BIFD.

OECD:

The Taxation of Income Derived from the Leasing of Containers

I. INTRODUCTION

1. When adopting, on 11th April, 1977, a Recommendation concerning the avoidance of double taxation, the Council recommended the Governments of Member countries to conform to the 1977 OECD Model Convention for the avoidance of double taxation with respect to taxes on income and capital, and instructed the Committee on Fiscal Affairs "to proceed to periodic reviews of situations where double taxation may occur, in the light of experience gained by Member countries, and to make appropriate proposals for its removal".

2. This report has been prepared by the Committee in that context, with a view to elucidating some of the issues related to the taxation of income derived from the leasing of containers – whatever is the type of transportation of such containers[1] – under the Model Convention or under bilateral treaties. The report also suggests lines for possible future action by Member countries in this field.

II. ECONOMIC BACKGROUND

1. General

3. The leasing of containers became an important activity during the 1970s. This was dependent on the "containerisation" of important parts of the world transportation system which took place in the previous decade. While in the first phase of this development, containers were generally owned by a carrier or ship-owner, in the second phase more and more containers were owned by separate enterprises and operated on a leasing basis. Today, container leasing enterprises (CLE) appear to own more than 50% of the world container population.[2].

4. This development took place because CLEs fulfil various functions in the complex environments of the world transportation system. Three functions can be clearly identified:

(a) CLEs provide carriers and other participants with containers, thereby providing an essential asset for the transportation business.
(b) CLEs perform a clearing function where containers are in surplus at one point and scarce at others; the enterprises thus perform an important service for the world transportation system.
(c) Leasing enterprises may participate in specific financial arrangements, e.g. in the case of fixed price buying options or full pay-out leases. They thus perform financial functions which are not necessarily essential to the world transportation system.

5. While all these functions are of relevance when considering a CLE, tax administrations are often concerned with some of these functions only, e.g. those performed by a specific establishment only having limited functions.

2. Business performances

6. The leasing of containers is a complex and world-wide activity. A single CLE normally handles tens of thousands of containers and may have to maintain more than 100 "depots" where its customers may pick up or redeliver the containers.

7. The operation of such a vast "pool" of containers, their world-wide movements, the cash flows and other commercial operations involved is almost totally dependent upon electronic data processing. The computer systems – normally situated at the headquarters of the CLE – are therefore an essential element in operating, controlling and assessing its world-wide business.

8. Accordingly, the daily activities are for the most part highly centralised, though a vast network of "depots" exists. The contracts with customers are negotiated and concluded either by the leasing company or by a local agent or, in some cases, by the operator of the depot (the operator of such a depot may also conclude contracts with customers). A major problem confronting the industry is the unbalanced flow of containers which results in their accumulating in one place while there are shortages in others. Once more, this can only be solved by centralisation and computerisation.

9. For the purposes of analysis, three countries or groups of countries have to be distinguished:

- the container leasing enterprise's *country of residence,* where this enterprise has the centre of its activities;
- the *countries of the various depots* between which containers move, being transported in an irregular way between different locations by a greater or lesser number of shipowners. The leasing enterprise may have specific installations in these countries, but it is more common for it to rely on wholly independent enterprises resident there;
- the *lessee's country* where a specific lessee has his residence or its head office; the leasing enterprise may or may not have a permanent establishment in this

1. Shipping, inland waterways, air freight, rail or road transportation, etc.
2. For the purpose of this report, container leasing enterprises do not include shipping companies exploiting containers as an activity of an auxiliary character, in the meaning of Article 5 (paragraph 4) of the 1977 Model Convention (cf. paragraph 10 of the Commentary on Article 8).

country for the conclusion of contracts or for the handling of containers reaching that country or for both.

3. Activities

10. The leasing of containers may assume various forms. The following seems a fair description and uses a terminology generally accepted in the industry:

(i) Trip leases for one or more trips, including:
- single-trip leases: leases from one depot to another;
- round-trip leases: leases from one depot for a round-trip back to the same depot or another depot in the same country;
- possible "mixed" leases, e.g. singel-trip leases with a round-trip option.

(ii) Short-term leases, for terms of less than one year, including:
- fixed minimum leasing time with open termination (e.g. minimum time 20 days, 3 months, 6 months, 9 months);
- minimum leasing time with renewal option (e.g. for 6 months, 12 months, 2 years, 3 years, etc);
- fixed leasing time (e.g. 30 days, 3 months, 9 months).

(iii)Long-term leases for leasing terms of one year or more, including contracts with:
- minimum leasing time with open termination;
- minimum leasing time with renewal option;
- minimum leasing time with premature cancellation option after 4, 3, 2, 1 years;
- fixed-price buying option or full pay-out leases (at the end of the leasing time the container automatically becomes the property of the leasing customer).

11. Leasing enterprises may also negotiate special agreements with their customers for leasing containers in certain operating areas, from and to certain depots, in certain quantities and at certain rates which are fixed for a specific period.

12. Generally speaking, rules of taxation are the same for all these activities. Problems may however arise where containers are leased in the context of specific financial arrangements or where special container equipment is being leased for exceptional purposes (e.g. atomic fuels transport). These cases are not dealt with in this report, but reference is made to the Committee's report on "The taxation of income derived from the leasing of industrial, commercial or scientific equipment".

III. RULES FOR THE TAXATION OF INCOME DERIVED FROM THE LEASING OF CONTAINERS UNDER THE OECD MODEL CONVENTION

1. Effects of existing rules

13. Income derived from the leasing of containers, being income from the leasing of industrial equipment, falls in the first instance under Article 12 (Royalties) and, where it is received by an enterprise, falls also within the scope of Articles 7 (Business profits), and 5 (Permanent establishment). Article 12 contains a specific rule which provides for no taxation in the State of source except where royalties are attributable to a permanent establishment in that State. As a consequence, enterprises leasing containers are, generally speaking, taxable in the State of residence. A number of countries have, however, entered a reservation on the exemption at source provided for under Article 12.

2. Options for a future revision of the Model Convention

14. The Committee has studied three different possibilities. A first possibility would be for the profits from the leasing of containers to be subjected to a limited tax at source where a bilateral treaty provides for such a tax on royalties in general. The Committee, in its large majority, found that this alternative would create major difficulties for the leasing of containers and for the international transportation system generally. It therefore rejected this solution. In connection with this, reference is made to the report on the leasing of industrial, commercial or scientific equipment which recommends the general exclusion of income from leasing of these assets from the scope of Article 12 of the OECD Model Convention.

15. Another possibility would be for profits from the leasing of containers to be, in the future, only subject to Articles 7 and 5 of the OECD Model. In order to avoid certain difficulties which have arisen from the fact that some countries have entered reservations on Article 12 and levy taxes at source on royalties under bilateral conventions (cf. Part V below), income from container leasing should be clearly excluded from the scope of Article 12. This would be in line with the OECD Model as such income is derived from a business activity. It seemed adequate to subject enterprises leasing containers to taxation in States where they have permanent establishments, and to avoid double taxation in the State of residence by using the methods set out in Articles 23A and 23B of the Model. Any practical difficulties or doubts for applying Articles 7 and 5 of the Model Convention might be sorted out by an adequate interpretation of these Articles and by having recourse to the mutual agreement procedure (Article 25). The principles developed in Part IV of this report would in fact form the basis for this approach. Such a solution met with a large support in the Committee.

16. Finally, the profits from the leasing of containers might be treated on a similar basis as profits from the operation of ships in international traffic and be taxed in accordance with Article 8 of the OECD Model, i.e. only in the State in which the place of effective management of the enterprise is situated (cf. paragraph 10 of the Commentary on Article 8). Such a solution is premised on the view that, in the absence of such a rule, the requisite allocation of rental income among various source States is inherently subject to the application of inconsistent allocation rules in those States and to arbitrary approximations, which can lead to the imposition of a prohibitive multiple tax burden. Exemption at source ensures that a tax will be imposed only where the overall leasing operations of an enterprise are profitable. Granting the tax

right to one State eliminates the need to develop complex rules for defining the profits to be taxed by each State, and the State in which the lessor is resident stands in the best position to account for the income and expense of a container leasing enterprise.

17. However, the Committee observed that, from the standpoint of principle, the problems raised by the taxation of income from container leasing differed little from the familiar problems that arose for implementing the principles of the OECD Model. A substantial majority of countries considered that container leasing was basically no different from the leasing of other industrial or scientific equipment, even if the containers were not used in the country of the first lessee. It would thus be unfortunate to create a precedent here that was contrary to the customary rules for taxation of this type of income. The Committee therefore does not recommend submitting container leasing income to the rules of Article 8, which might, however, be examined in the light of new experience when the OECD Model is fully revised. Pending this revision, countries which favour submitting income from container leasing to the rules of Article 8 are free to suggest this solution when entering into bilateral negotiations.

IV. APPLICATION OF THE OECD MODEL CONVENTION

1. General

18. While the OECD Model is in itself clear, it raises a number of practical problems.

(a) A first problem relates to the question of whether the leasing enterprise has permanent establishments within the meaning of Article 5 of the OECD Model. This may be unclear, e.g. in States where depots are situated, when the activities of the enterprise are often so limited that it is difficult to establish whether or not these activities, taken in themselves, would qualify for exemption under paragraph 4 of Article 5 of the OECD Model. Likewise it may be doubtful whether there is or is not a permanent establishment in the State of a customer (e.g. carrier or other user of the containers) by the mere fact of the presence of containers there.

(b) Determining which profits of an enterprise leasing containers are attributable to a permanent establishment qualifying as such under Article 5 of the OECD Model may be even more difficult.

2. Guidelines for the application of Article 5 of the OECD Model (existence of a permanent establishment)

19. The Committee decided to approach this problem by examining some basic cases often encountered in the operation of CLEs. The solutions proposed could constitute guidelines for policy-making and mutual agreement procedures regarding the application of bilateral treaties. This does not mean, of course, that the specific circumstances of each case should not be taken into account.

Case A: Simple depots

(i) *Case description*

20. The leasing enterprise rents containers all over the world. The lessee may surrender his container to any one of more than 100 depots in 40 countries. Most depots are owned and operated by independent enterprises taking over the containers and delivering them to their new customers. The depot operator generally receives a lump sum plus a special fee depending on the actual use of the depot and the services actually performed. The operation of the depot will normally require the following activities:

- being notified of the arrival of containers which will be put at the disposal of the leasing enterprise;
- notification of demands for containers;
- managing a deposit for containers which have to be kept at the port under the disposition of the leasing enterprise;
- handling of containers, namely receiving them from shipping enterprises or delivering to them on demand;
- control of containers returned to the enterprise or delivered by it;
- technical inspection establishing whether there is damage, informing the CLE in case of damage and auxiliary services to provide for repair through third parties.

The depot is normally used by several enterprises including container leasers, auto transporters, ocean carriers.

(ii) *Guidelines*

21. The Committee suggests that a simple depot, as described above, does not normally give rise to a permanent establishment if operated by an independent enterprise. In cases where the operator serves as a depot for only one enterprise it might, however, be necessary to examine whether an operating depot as described in Case D below does not in fact exist.

22. A simple depot might, however, be deemed a permanent establishment in the meaning of Article 5, paragraph 1 of the OECD Model if owned and operated by the CLE itself. A strong majority of the Committee holds, however, that in these circumstances the establishment should not generally be deemed to be a permanent establishment under Article 5, paragraph 4 of the OECD Model. This appears to be justified because:

- many activities of such establishments come under the wording of sub-paragraphs (a) and (b) of Article 5, paragraph 4;
- the remaining activities are generally so limited as to be regarded as being of an auxiliary character within the meaning of sub-paragraph (e) of paragraph 4;
- the activity of a depot constitutes only a small part of that of the enterprise as a whole and it would hardly be possible to individuate more than an insubstantial amount of profits attributable to it;
- consequently, the overall activity resulting from the combination of activities falling under subparagraphs (a), (b) and (e) is of an auxiliary character within the meaning of sub-paragraph (f) of paragraph 4.

23. The Committee therefore recommends applying the rules for exceptions provided in Article 5, paragraph 4 of the OECD Model in the cases mentioned above.

Case B: Depot-Agence

(i) *Case description*

24. The lessor maintains agencies which rent the containers to customers approaching them. The contracts are normally signed by the agent who will closely observe general guidelines, special instructions or specific orders of the lessor, as the case may be. The agent may be fully independent of the lessor and serve more than one enterprise leasing containers. There may, however, also be closer relationships with the lessor.

(ii) *Guidelines*

25. Where a depot-agence is owned and operated by a third party having an independent status and acting in the ordinary course of its business, it is not to be deemed a permanent establishment under Article 5, paragraph 6 of the OECD Model. Otherwise, it should be deemed a permanent establishment under Article 5, paragraph 5 of the OECD Model.

26. After careful consideration the Committee, in its vast majority, recommends granting the status of an independent agent if the operator is dealing with more than one enterprise, since the criteria described in paragraph 35 of the Commentary are met in such circumstances. Other cases should be examined on a case by case basis in the light of paragraphs 36 and 37 of the Commentary on Article 5.

27. Where the depot-agence is owned and operated by the CLE itself, the Committee considers that a permanent establishment clearly exists.

Case C: Inspection and repair

(i) *Case description*

28. Containers deposited in a depot are inspected and, in the event of unacceptable damage, repaired on request of the lessor. Normally, this will be done by independent inspectors and/or repair shops (normal technical inspection stating whether there is any damage at all will normally be carried out by the depot operator). In some cases the lessor may own a repair shop in ports of special importance.

(ii) *Guidelines*

29. The Committee is of the opinion that inspection and repair through independent enterprises does not constitute a permanent establishment. Even in the special cases where this might be regarded as a fixed place of business, paragraph 4 (e) and (f) should lead to the conclusion that there is no permanent establishment.

Case D: Operational branches

(i) *Case description*

30. The lessor maintains an office in a port to take care of all its operations in the region; this would include notification of arrival and demands, operating the depot for containers, handling them and carrying on inspection and repair. It would likewise include, under the supervision of the head office, the lessor's marketing and the acquisition of contracts. Such operational branches appear to be set up principally in order to co-ordinate the CLE's activity on a regional basis.

(ii) *Guidelines*

31. In these cases, the application of Article 5 of the OECD Model will usually lead to the existence of a permanent establishment.

Case E: Mere presence of containers

(i) *Case description*

32. Containers of the lessor are used in the country by, or on behalf of, the lessee or a third person.

(ii) *Guidelines*

33. It is clear that in such a case the mere presence of the containers does not constitute a permanent establishment as there is no fixed place of business nor any activity performed by the lessor.

3. Guidelines for the application of Article 7 of the OECD Model (profit allocation)

34. The guidelines for the application of Article 5 of the OECD Model as set out above will prevent the CLE's profits from being split up excessively. The Committee agreed therefore that relatively general guidelines would meet the situation from a practical point of view.

35. Only in exceptional cases would a simple depot and a depot-agence [Cases A and B] be regarded as permanent establishments. Allocation of profits should be based on the fact that the permanent establishment in these cases is not active in the business of leasing containers, but rather rendering limited services. Its profits, therefore, should be determined by:

(a) the amount a distinct and separate enterprise would receive under similar conditions as a consideration for holding a depot (e.g. a lump-sum payment and/or a special fee dependent on the actual use of the depot),

(b) less: expenses incurred for the purposes of the depot,

(c) less: an appropriate share of the headquarters' expenses including executive and general administrative expenses (if not otherwise taken into account).

36. Problems may be different in the case of an operational establishment [Case D]. In calculating the profits attributable to it, functions between such a permanent establishment and the headquarters of the lessor should be carefully weighted. Expenses including executive and general administrative expenses incurred at the headquarters should be deducted. This would cover, inter alia, expenditure for financing containers, depreciation and management.

37. In Cases A and B, the profits to be allocated to the permanent establishment would normally be small. This can only be ascertained at the headquarters. States taxing such profits might, under a mutual agreement procedure, rely on the amounts determined in the headquar-

ters' books and the country in which the headquarters is located might, in such a case, undertake to examine these amounts when auditing the CLE and to advise the other State in the case of some serious deficiency being ascertained.

V. PROBLEMS REGARDING ARTICLES ON ROYALTIES IN BILATERAL CONVENTIONS

38. The application of articles on royalties in bilateral conventions does not give rise to difficulties as long as they provide for no taxation at source on payments (rents) for container leasing. This would be in line with Article 12 of the OECD Model which exempts royalties (including rents) for scientific, industrial or commercial equipment from taxation in the State of Source.

39. There are, however, bilateral conventions which provide for a limited tax at source on royalties. Reference is made in this respect to the report on the taxation of income derived from the leasing of industrial, commercial or scientific equipment the conclusions of which also cover income from the leasing of containers. In that report, the Committee takes the view that income from leasing should not be subjected to taxation at source and, therefore, be excluded from the scope of provisions corresponding to Article 12. Furthermore, it recommends making appropriate amendments to that Article or the Commentary thereto in an eventual revision of the OECD Model.

40. The question may be asked whether it is cogent to apply the provision of bilateral conventions providing for a tax at source on royalties (including rents on industrial, commercial or scientific equipment) to rents from the leasing of containers. These bilateral conventions normally use the language of Article 12, paragraph 2 of the OECD Model in defining the term "royalties". No consensus on this question could be reached in the Committee.

(a) One line of argument was that the leasing of containers is presently, according to the strict wording of such treaties, always to be regarded as "leasing of . . . industrial equipment". This might be supported by the fact that the Commentary on Article 12 of the OECD Model appears to follow this line. As the wording of the Model is quite clear, only a change in the Model could alter the situation.

(b) On the other hand, it has been argued that the economic reality of container leasing goes far beyond the simple lease of a tangible good. The advent of container leasing was not due to the wish of carriers to rent rather than own containers. The economic reason underlying this development was rather the wish to be able to pick up and leave a container wherever it is convenient for the carrier to do so. This is only made possible by the fact that the leasing enterprises have built up a world-wide network of installations and perform a kind of clearing function where there is a surplus of containers at one point and a scarcity at others. The enterprise thus performs a service in balancing supply and demand for containers on a world-wide scale: the lease is an instrument rather than an ultimate end in itself. As Article 12 of the OECD Model deals only with situations where the lease is the ultimate end, it is not applicable to container leasing.

41. While the majority of countries adhered to the first interpretation, a minority preferred the second alternative as a functional interpretative approach. The Committee as a whole stated that the problem was due to the fact that bilateral conventions deviate from Article 12 of the OECD Model and that a common solution could not be envisaged. However, it recommends that Contracting States make use of the mutual agreement procedure, where this is possible, in order to avoid double taxation or harmful effects caused by taxation at source on royalties.

42. In this context, difficulties in the application and in the interpretation of conventions which may arise where taxation at source may be imposed on payments for the leasing of containers have been considered by the Committee. Reference is made to paragraphs 16 to 20 of the above-mentioned report on the leasing of industrial, commercial and scientific equipment.

VI. CONCLUSIONS

43. The Committee has come to the conclusion that the approach adopted in the Model convention does provide for satisfactory solutions and that there is no reason to depart from principles applicable to other enterprises. In order to facilitate the application of these principles to container leasing enterprises and having due regard to what is said in Part V above, the Committee suggests that the Council may wish to:

(a) Recommend Member countries, when applying existing bilateral conventions to enterprises leasing containers:
   (i) to take account of the considerations set out in Parts IV and V of the present report for the interpretation of Articles 5, 7 and 12 of the OECD Model Convention.
   (ii) to resolve administrative difficulties of application of these Articles by way of mutual agreement;
   (iii) to grant relief where possible, either under Article 25 of the OECD Model Convention or under their domestic laws, in order to avoid double taxation or other harmful effects caused by the taxation at source of such income;

(b) Recommend Member countries, when concluding new conventions or revising existing ones, not to subject income from the leasing of containers to provisions under which such income may be subject to taxation at source.

44. The Committee suggests that the Council may wish to instruct it to take into account suggestions made in this report regarding the scope of Article 12 when the OECD Model Convention is next revised.

45. The Committee also suggests that the present report be published and given appropriate publicity by the OECD Secretariat.

VII. RESERVATIONS

46. *Australia* reserves the right to tax income derived from the leasing of containers as royalties under its double taxation agreements, where such income, under Australian law, has a source in Australia.

47. *Canada* reserves the right to retain a 10% rate of tax at source on income derived from the leasing of containers. However, Canada would be prepared to agree to apply, on a reciprocal basis, the rules of Article 8 to income derived from the leasing of containers used in international traffic.

48. *Italy* reserves the right to continue to include income derived from the leasing of containers in the definition of royalty as provided for in paragraph 2 of Article 12 of the 1977 Model Convention.

49. *New Zealand, Portugal* and *Spain* reserve the right to tax at source income from the leasing of containers.

50. *Turkey* reserves the right to subject income from the leasing of containers to a withholding tax at source in all cases. In case of the application of the Articles 5 and 7 of the Model Convention to such income, Turkey would like to apply the permanent establishment rule to the simple depot, depot-agence and operational branches cases.

51. *Greece* reserves the right to continue to consider income derived from the leasing of containers as royalties and to tax such income accordingly.

Recommendation of the Council

Concerning the Avoidance of Double Taxation of Income Derived from the Leasing of Containers

(Adopted by the Council at its 591st Meeting on 13th September, 1983)

The Council,

Having regard to Article 5(b) of the Convention on the Organisation for Economic Co-operation and Development of 14th December, 1960;

Having regard to the Recommendation of the Council of 11th April, 1977 concerning the avoidance of double taxation;

Having regard to the report of the Committee on Fiscal Affairs of 17th June, 1983 on the taxation of income derived from leasing of containers;

Considering the need to remove the obstacles that double taxation presents to the free movement of goods, services, capital and manpower between Member countries of the OECD by the conclusion of Conventions between them for that purpose;

Considering that the OECD Model Double Taxation Conventions have helped Member countries to harmonize bilateral conventions on the basis of uniform principles, definitions, rules and methods, to agree on a common interpretation and to extend the existing network of such conventions;

Considering the need to proceed to periodic reviews of situations where double taxation may occur, in the light of experience gained by Member countries, and to make appropriate proposals for its removal:

I. RECOMMENDS the Governments of Member countries;

1. when applying existing bilateral conventions to enterprises leasing containers:
   (i) to take account of the considerations set out in Parts III and IV of the above-mentioned report for the interpretation of Articles 5, 7 and 12 of the OECD 1977 Model Double Taxation Convention on Income and Capital (hereinafter referred to as the "Model Convention"),
   (ii) to resolve administrative difficulties of application of these Articles by way of mutual agreement,
   (iii) to grant relief where possible, either under Article 25 of the Model Convention or under their domestic laws, in order to avoid double taxation or other harmful effects caused by the taxation at source of such income;
2. when concluding new conventions or revising existing ones, not to subject income derived from the leasing of containers to provisions under which such income may be subject to taxation at source.

II. INSTRUCTS the Committee on Fiscal Affairs to take into account suggestions made in the above-mentioned report regarding the scope of Article 12 when the Model Convention is next revised.

United States – People's Republic of China Tax Treaty of 30 April 1984

AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME

The Government of the United States of America and the Government of the People's Republic of China,

Desiring to conclude an Agreement for the avoidance of double taxation and the prevention of tax evasion with respect to taxes on income,

Have agreed as follows:

Article 1

This Agreement shall apply to persons who are residents of one or both of the Contracting States.

Article 2

1. The taxes to which this Agreement applies are:

a) in the People's Republic of China:
   (i) the individual income tax;
   (ii) the income tax concerning joint ventures with Chinese and foreign investment;
   (iii) the income tax concerning foreign enterprises;
   (iv) the local income tax;
   (hereinafter referred to as "Chinese tax").

b) in the United States of America: the Federal income taxes imposed by the Internal Revenue Code;
   (hereinafter referred to as "United States tax").

2. The Agreement shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Agreement in addition to, or in place of, those referred to in paragraph 1. Within an appropriate time period, the competent authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective taxation laws.

Article 3

1. In this Agreement, unless the context otherwise requires:

a) the term "the People's Republic of China", when used in a geographical sense, means all the territory of the People's Republic of China, including its territorial sea, in which the laws relating to Chinese tax are in force, and all the area beyond its territorial sea, including the sea-bed and subsoil thereof, over which the People's Republic of China has jurisdiction in accordance with international law and in which the laws relating to Chinese tax are in force;

b) the term "the United States of America", when used in a geopgraphical sense, means all the territory of the United States of America, including its territoral sea, in which the laws relating to United States tax are in force, and all the area beyond its territorial sea, including the sea-bed and subsoil thereof, over which the United States of America has jurisdiction in accordance with international law and in which the laws relating to United States tax are in force;

c) the terms "a Contracting State" and "the other Contracting State" mean the People's Republic of China or the United States of America, as the context requires;

d) the term "tax" means Chinese tax or United States tax, as the context requires;

e) the term "person" includes an individual, a company, a partnership and any other body of persons;

f) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

g) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting term "person" includes an individual, a company, a partnership and any other body of persons;

h) the term "nationals" means all individuals having the nationality of a Contracting State and all legal persons, partnerships and other bodies of persons deriving their status as such from the law in force in a Contracting State;

i) the term "competent authority" means:
   (i) in the People's Republic of China, the Ministry of Finance or its authorized representative; and
   (ii) in the United States of America, the Secretary of the Treasury or his authorized representative.

2. As regards the application of the Agreement by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State concerning the taxes to which the Agreement applies.

Article 4

1. For the purposes of this Agreement, the term "resident of a Contracting State" means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his domicile, residence, place of head office, place of incorporation or any other criterion of a similar nature.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then the competent authorities of the Contracting States shall determine through consultations the Contracting State of which that individual shall be deemed to be a resident for the purposes of this Agreement.

3. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then the competent authorities of the Contracting States shall determine through consultations the Contracting State of which the company shall be deemed to be a resident for the purposes of this Agreement, and, if they are unable to so determine, the company shall not be considered to be a resident under this Agreement.

4. Where by reason of the provisions of paragraph 1 a company is a resident of the United States of America, and, under a tax agreement between the People's Republic of China and a third country is also a resident of that third country, the company shall not be considered to be a resident of the United States of America for purposes of enjoying benefits under this Agreement.

Article 5

1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop; and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" also includes:

a) a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;

b) an installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months; and

c) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve-month period.

4. Notwithstanding the provisions of paragraphs 1 through 3, the term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) through e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person, other than an agent of an independent status to whom paragraph 6 applies, is acting on behalf of an enterprise and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that Contracting State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other Contracting State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's length conditions.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6

1. Income derived by a resident of a Contracting State from real property situated in the other Contracting State may be taxed in that other Contracting State.

2. The term "real property" shall have the meaning which it has under the laws of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as real property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting or use in any other form of real property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Article 7

1. The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other Contracting State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the head office of the enterprise or any of its other offices.

4. Insofar as the tax law of a Contracting State provides with respect to a specific industry that the profits to be attributed to a permanent establishment are to be determined on the basis of a deemed profit, nothing in paragraph 2 shall preclude that Contracting State from applying those provisions of its law, provided that the result is in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of paragraphs 1 through 5, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 8

1. Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case the relationship between the two enterprises in their commercial or financial relations differs from that which would exist between independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by the reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that Contracting State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other Contracting State, and the profits so included are profits which whould have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other Contracting State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Agreement and the competent authorities of the Contracting States shall if necessary consult each other.

Article 9

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that Contracting

State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed 10% of the gross amount of the dividends.
This paragraph shall not affect the taxation of the company in respect of the profits out which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the taxation laws of the Contracting State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that Contracting State independent personal services from a fixed base situated therein, and the holding or other corporate rights in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other Contracting State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other Contracting State or insofar as the holding or other corporate rights in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other Contracting State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that other Contracting State.

Article 10

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed 10% of the gross amount of the interest.

3. Notwithstanding the provisions of paragraph 2, interest arising in a Contracting State and derived by the government of the other Contracting State, a political subdivision or local authority thereof, the Central Bank of that other Contracting State or any financial institution wholly owned by the government, or by any resident of the other Contracting State with respect to debt-claims indirectly financed by the government of that other Contracting State, a political subdivision or local authority thereof, the Central Bank of that other Contracting State or any financial institution wholly owned by that government, shall be exempt from tax in the first-mentioned Contracting State.

4. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures.

5. The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

6. Interest shall be deemed to arise in a Contracting State when the payer is the government of that Contracting State itself, a political subdivison, a local authority or a resident of that Contracting State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payment shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Agreement.

Article 11

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed 10% of the gross amount of the royalties.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films or films or tapes used for radio or television broadcasting, any patent, technical know-how, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein; or performs in that other Contracting State independent personal services from a ficxed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

5. a) Royalties will be deemed to arise in a Contracting State when the payer is the government of that Contracting State itself, a political subdivision, a local authority or a resident of that Contracting State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.
b) Where under subparagraph a) royalties do not arise in one of the Contracting States, and the royalties relate to the use of, or the right to use, the right or property in one of the Contracting States, the royalties shall be deemed to arise in that Contracting State.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Agreement.

Article 12

1. Gains derived by a resident of a Contracting State from the alienation of real property referred to in Article 6 and situated in the other Contracting State may be taxed in that other Contracting State.

2. Gains from the alienation of movable (personal) property forming part of the business assets of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or of movable (personal) property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose

of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or such a fixed base, may be taxed in that other Contracting State.

3. Gains derived by a resident of a Contracting State from the alienation of ships or aircraft operated in international traffic and of movable (personal) property pertaining to the operation of such ships or aircraft shall be taxable only in that Contracting State.

4. Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of real property situated in a Contracting State may be taxed in that Contracting State.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of 25% in a company which is a resident of a Contracting State may be taxed in that Contracting State.

6. Gains derived by a resident of a Contracting State from the alienation of any property other than that referred to in paragraphs 1 through 5 and arising in the other Contracting State may be taxed in that other Contracting State.

Article 13

1. Income derived by an individual who is a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that Contracting State, unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities or he is present in that other Contracting State for a period or periods exceeding in the aggregate 183 days in the calendar year concerned. If he has such a fixed base or remains in that other Contracting State for the aforesaid period or periods, the income may be taxed in that other Contracting State, but only so much of it as is attributable to that fixed base or is derived in that other Contracting State during the aforesaid period or periods.

2. The term "professional services" includes, especially, independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 14

1. Subject to the provisions of Articles 15, 17, 18, 19 and 20, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that Contracting State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other Contracting State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other Contracting State for a period or periods not exceeding in the aggregate 183 days in the calendar year concerned; and

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other Contracting State; and

c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other Contracting State.

Article 15

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other Contracting State.

Article 16

1. Notwithstanding the provisions of Articles 13 and 14, income derived by a resident of a Contracting State as entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other Contracting State.
However, income derived by a resident of a Contracting State as an entertainer or athlete from activities exercised in accordance with a special program for cultural exchange agreed upon by the governments of both Contracting States shall be exempt from tax by the other Contracting State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 13 and 14, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.
However, if those activities are exercised in accordance with a special program for cultural exchange agreed upon by the governments of both Contracting States, the income so derived shall be exempt from tax by that Contracting State.

Article 17

1. Subject to the provisions of paragraph 2 of Article 18, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that Contracting State.

2. Notwithstanding the provisions of paragraph 1, pensions and other payments made by the government, a political subdivision or a local authority of a Contracting State under its social security system or public welfare plan shall be taxable only in that Contracting State.

Article 18

1. a) Remuneration, other than a pension, paid by the government or a political subdivision or a local authority of a Contracting State to an individual in respect of services rendered to that government or subdivision or authority shall be taxable only in that Contracting State.

b) However, such remuneration shall be taxable only in that other Contracting State if the services are rendered in that other Contracting State and the individual is a resident of that other Contracting State who:
(i) is a national of that other Contracting State; or
(ii) did not become a resident of that other Contracting State solely for the purpose of rendering the services.

2. a) Any pension paid by, or out of funds created by, the government or a political subdivision or a local authority of a Contracting State to an individual in respect of services rendered to that government or subdivision or authority shall be taxable only in that Contracting State.
b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other Contracting State

3. The provisions of Articles 14, 15, 16 and 17 shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by the government or a political subdivision or a local authority of a Contracting State.

Article 19

An individual who is, or immediately before visiting a Contracting State was, a resident of the other Contracting State and is temporarily present in the first-mentioned Contracting State for the primary purpose of teaching, giving lectures or conducting research at a university, college, school or other accredited educational institution or scientific research institution in the first-mentioned Contracting State shall be exempt from tax in the first-mentioned Contracting State for a period not exceeding three years in the aggregate in respect of remuneration for such teaching, lectures or research.

Article 20

A student, business apprentice or trainee who is, or was immediately before visiting a Contracting State, a resident of the other Contracting State and who is present in the first-mentioned Contracting State solely for the purpose of his education, training or obtaining special technical experience shall be exempt from tax in that Contracting State with respect to:

a) payments received from abroad for the purpose of his maintenance, education, study, research or training;

b) grants or awards from a government, scientific, educational or other tax-exempt organization;

c) income from personal services performed in that Contracting State in an amount not in excess of 5,000 United States dollars or its equivalent in Chinese yuan for any taxable year.

The benefit provided under this Article shall extend only for such period of time as is reasonably necessary to complete the education or training.

Article 21

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Agree-

ment shall be taxable only in that Contracting State.

2. The provisions of paragraph 1 shall not apply to income other than that from real property as defined in paragraph 2 of Article 6 if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or 13, as the case may be, shall apply.

3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Agreement and arising in the other Contracting State may also be taxed in that other Contracting State.

Article 22

1. In the People's Republic of China, double taxation shall be eliminated as follows:

a) where a resident of China derives income from the United States, the amount of the United States income tax payable in respect of that income in accordance with the provisions of this Agreement shall be allowed as a credit against the Chinese tax imposed on that resident. The amount of credit, however, shall not exceed the amount of the Chinese tax computed with respect to that income in accordance with the taxation laws and regulations of China;

b) where the income derived from the United States is a dividend paid by a company which is a resident of the United States to a company which is a resident of China and which owns not less than 10% of the shares of the company paying the dividend, the credit shall take into account the United States income tax payable by the company paying the dividend in respect of the profits out of which the dividends are paid.

2. In the United States of America, in accordance with the provisions of the law of the United States, the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income:

a) the income tax paid to China by or on behalf of such resident or citizen; and

b) in the case of a United States company owning at least 10% of the voting rights in a company which is a resident of China and from which the United States company receives dividends, the income tax paid to China by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph of this Agreement, the taxes referred to in paragraphs 1a) and 2 of Article 2 shall be considered income taxes.

3. Income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Agreement shall be deemed to arise in that other Contracting State.

Article 23

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other Contracting State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, apply to persons who are not residents of one or both of the Contracting States.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other Contracting State than the taxation levied on enterprises of that Contracting State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Except where the provisions of Article 8, paragraph 7 of Article 10 or paragraph 6 of Article 11 apply, interest, royalties and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned Contracting State are or may be subjected.

Article 24

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Agreement, he may, irrespective of the remedies provided by the domestic law of those Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 23, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of this Agreement.

2. The competent authority shall endevor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case through consultation with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Agreement. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Agreement. They may also consult together for the elimination of double taxation in cases not provided for in this Agreement.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of paragraphs 2 and 3. To facilitate reaching a mutual agreement, the competent authorities of both Contracting States may meet for an oral exchange of opinions.

Article 25

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic laws of the Contracting States concerning taxes covered by this Agreement insofar as the taxation thereunder is not contrary to this Agreement, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Article 26

Nothing in this Agreement shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

Article 27

Each of the Contracting States shall notify the other Contracting State in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring this Agreement into force. The Agreement shall enter into force on the thirtieth day after the date of the latter of such notifications and shall take effect as respects income derived during taxable years beginning on or after the first day of January next following the date on which this Agreement enters into force.

Article 28

This Agreement shall remain in force indefinitely, be either Contracting State may terminate the Agreement by giving notice to the other Contracting State in writing through diplomatic channels on or before 30 June in any calendar year after five years from the date on which this Agreement enters into force. In such event, the Agreement shall cease to have effect with respect to income derived during taxable years beginning on or after the first day of January of the year following that in which the notice of termination is given.

DONE at Beijing the 30th day of April, 1984, in duplicate, in the Chinese and English languages, the two texts having equal authenticity.

Both sides agree that a tax sparing credit shall not be provided in Article 22 of this Agreement at this time. However, the Agreement shall be promptly amended to incorporate a tax sparing credit provision if the United States hereafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.

His Excellency:
Zhao Ziyang
Premier of the People's Republic of China

I have the honor to request Your Excellency to confirm the foregoing understanding on behalf of Your Excellency's Government.

I avail myself of this opportunity to assure Your Excellency of my highest consideration.
Ronald W. Reagan
President of the United States of America

PROTOCOL TO THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME

At the signing of the Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income (hereinafter referred to as "the Agreement "), both sides have agreed upon the following provisions which form an integral part of the Agreement:

1. This Agreement shall not restrict in any manner any tax benefit which is or may hereafter be accorded in a Contracting State by the laws of that Contracting State or by an Agreement between the governments of the Contracting States.

2. Notwithstanding any provision of the Agreement, the United States may tax its citizens. Except as provided in paragraph 2 of Article 8, paragraph 2 of Article 17, and Articles 18, 19, 20, 22, 23, 24 and 26 of this Agreement, the United States may tax its residents (as determined under Article 4).

3. The United States may impose its social security tax, its personal holding company tax and its accumulated earnings tax notwithstanding any provision of this Agreement. However, a Chinese company shall be exempt from the personal holding company tax or the accumulated earnings tax in the United States during a taxable year if during that taxable year the company is wholly-owned, directly or indirectly, either by one or more individuals who are residents of China (and who are not citizens of the United States) or by the Government of China or any wholly-owned agency thereof.

4. The term "person" as defined in Article 3 of the Agreement shall include an estate or a trust.

5. In applying paragraph 2 of Article 4 of this Agreement, the competent authorities of both Contracting States shall be guided by the rules contained in paragraph 2 of Article 4 of the United Nations Model Double Taxation Convention between Developed and Developing Countries.

6. For purposes of paragraph 3 of Article 11 of this Agreement, it is agreed by both sides that, in the case of royalties paid for the rental of industrial, commercial or scientific equipment, the tax shall be imposed on 70% of the gross amount of such royalties.

7. It is agreed by both sides that the competent authorities of the Contracting States may through consultation deny the benefits of Articles 9, 10 and 11 to a company of a third country if the company becomes a resident of a Contracting States for the principal purpose of enjoying benefits under this Agreement.

8. This Agreement shall not affect the application of the agreement between the two government with respect to mutual exemption from taxation of transportation income of shipping and air transport enterprises, signed at Beijing on 5 March 1982.

DONE at Beijing on the 30th day of April, 1984, in duplicate, in the Chinese and English languages, the two texts having equal authenticity.

[EXCHANGE OF NOTES]

Beijing, April 30, 1984

Excellency:
I have the honor to refer to the Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Agreement") and to confirm, on behalf of the Government of the United States of America, the following understanding reached between the two Governments:

Beijing, April 30, 1984

Excellency:
I have the honor to acknowledge receipt of Your Excellency's Note of today's date, which reads as follows:
"Excellency:
I have the honor to refer to the Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Agreement") and to confirm, on behalf of the Government of the United States of America, the following understanding reached between the two Governments:

Both sides agree that a tax sparing credit shall not be provided in Article 22 of this Agreement at this time. However, the Agreement shall be promptly amended to incorporate a tax sparing credit provision if the United States hereinafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.

I have the honor to request Your Excellency to confirm the foregoing understanding on behalf of Your Excellency's Government.

I avail myself of this opportunity to assure Your Excellency of my highest consideration."

His Excellency:
Ronald W. Reagan
President of the United States of America

I have the honor to confirm the understanding contained in Your Excellency's Note on behalf of the Government of the People's Republic of China.

I avail myself of this opportunity to assure Your Excellency of my highest consideration.
Zhao Ziyang
Premier of the People's Republic of China

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Australian Resources Rent Tax

(continued from page 261)

Where the exploration subsidy applies, the abovementioned RRT threshold and tax rates each reduce by 5% and a progressive tax rate applies.

The tax unit is to be the individual project and not the company. It is to be restricted to the profits derived within the boundaries of the petroleum development project. Deductions will be limited to those necessary to produce a marketable commodity and so realize the resource rent. The rules already established in the Income Tax Assessment Act are generally thought to be sufficient to determine what constitutes "petroleum mining".

Discussions on the final details of the RRT are continuing with industry representatives. Discussions are being held with the States as to compensation by the Federal Government for loss of royalty revenue.

At this stage it appears that the RRT will be levied prior to company income tax and allowed as a deduction in determining the company's taxable income. No information is available concerning the treatment of RRT under the various double taxation agreements.

IFA news

CANADIAN BRANCH

Seminar on U.S. taxation

On 29-31 May 1984 a seminar on U.S. taxation for Canadian practitioners was held, organized by Nathan Boidman, who has also acted as its chairman. The following subjects were discussed: U.S. jurisdiction to tax; the taxation of income effectively connected to a U.S. trade or business – rules for computing taxable income for U.S. business operations – rules for taxes payable by corporations; update on unitary tax issues; special intercompany issues in connection with the concept of "effectively connected income" – capitalization of a U.S. business – taxation of non-effectively connected income; taxation of personal service income and of individuals in general; shareholder-corporation transactions; corporate takeovers, reorganizations and liquidations; enforcement, compliance and interpretation.

GERMAN BRANCH

Joint Austrian-German-Luxembourg Seminar

On 18 and 19 May 1984 the Austrian, German and Luxembourg members of IFA held a joint seminar in Regensburg (Federal Republic of Germany). The subjects discussed were:

- Changes in the tax laws of Austria, Germany and Luxembourg in 1982-83 and the direction tax policy is expected to take in these countries.
- Depreciation rules in Austria, Germany and Luxembourg and the the role played by the EC-Commission with respect to the harmonization of depreciation.
- Recent work performed by the OECD Fiscal Committee.

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V. BIBLIOGRAPHY

In next issues:

The Zimbabwe 1983 Budget
– by *D.G. Murphy*

U.S.A.: Options for systems replacing worldwide unitary taxation

Argentina's double taxation agreements
– by *Maximo Bomchil, Jr.*

Taxation in Latin America
– by *Edison Gnazzo Lima* and *Ramón Valdés Costa*

Hong Kong's new revenue proposals and their implications
– by *Y.C. Jao*

Tax havens in the Caribbean Basin

Morocco: Foreign investment regulations
– by *Servaas van Thiel*

U.S.S.R.: The 1984 Budget Act and the tax system
– by *Prof. Dr. Tibor Nagy*

NETHERLANDS:

Unitary Taxation – a Foreign Government's View

By H.E. Koning, State Secretary for Finance

Official text of a speech delivered on 17 May 1984 at a meeting organized by the Netherlands Chamber of Commerce of America in Amsterdam.

As State Secretary for Finance specially responsible for matters relating to taxation it is a pleasure to me to present in detail the position of the Netherlands Government toward the phenomenon of worldwide unitary taxation.

In the following I will first deal with the principal objections of my Government against unitary taxation. Then I will discuss the relation between unitary taxation and international conventions and international economic relations. Finally I will try to give an outlook of the future of economic and fiscal relations between the Netherlands and the United States.

Starting with the chapter "objections against worldwide unitary taxation" I would summarize our principal objections as follows:

- unitary taxation disregards legal and economic organisation of business activities and presumes irrefutably a relationship between certain defined factors and profits or income produced by activities within a taxing jurisdiction;
- unitary taxation, because of its abstraction from actual circumstances, produces unfair and inequitable results: unfair and inequitable tax liabilities;
- unitary taxation amounts to extra-territorial taxation and legislation and is as such in contravention of international law.

The first objection is in my opinion a very important one, namely that unitary taxation disregards the actual circumstances of individual taxpayers. Whenever a business is deemed to be a unitary business each dollar of expenses is deemed to produce the same amount of profit wherever the expense was made. Although this presumption may be right in certain well defined circumstances, it clearly disregards differences in economic climates internationally and differences in profitability between various activities within a unitary business. The basic presumption underlying unitary taxation leads to the result that where the business as a whole makes a profit every unit of it is apportioned a profit. Where on the other hand the business as a whole has made a loss, no single unit of it can be attributed a profit. In our opinion this simply does not reflect the true facts of economic life. It is not unusual for a certain activity of a generally profitable business to sustain a loss in a given year or, on the reverse, to produce a profit in a generally loss-making situation. Thus as soon as unitary taxation is applied outside the limits of a homogeneous economic environment, it distorts the results of separate activities in different locations.

In addition to the distortion of the allocation of profits which is inherent in unitary taxation, the practical application of this method of taxation has shown an extension of the concept of a unitary business far beyond the limits of what could be considered a meaningful concept. Where a unitary business is presumed to exist by virtue only of a certain degree of share-ownership and the existence of other economic relations between the several units is immaterial, the concept of a unitary business is stretched too far to make sense anymore. Recent years have shown practical examples of the completely unrealistic results caused by unitary taxation. In the case of Shell, as we have been told, unitary apportionment leads to the apportionment of a profit to a subsidiary which actually had suffered losses of several hundreds of millions of dollars over the taxable years in question. And also in other cases the use of formula apportionment has lead to apportionment of vastly disproportionate amounts of profits to the states using these formulae. This is not to say that formula apportionment can in no case operate to the advantage of a taxpayer. The best known recent example of this situation was presented by Caterpillar a few years ago. From these examples a picture of arbitrariness emerges, which is only affirmed by the events in the state of Florida following the Supreme Court's Container decision. Statements like unitary apportionment being a pot of money in the street waiting to be grabbed can only confirm the impression of arbitrariness of that method. In my opinion this condemns the system.

The second objection against worldwide unitary taxation is that it leads to unfair and inequitable results. The method of unitary apportionment of the worldwide profits of an enterprise to the different taxing jurisdictions in which that enterprise operates is in theory a workable method. If the same formula would be used by every tax administration involved and the apportionment would be made consistently, then the results of such apportionment would be acceptable as would be any other method and no inconsistencies between different methods would occur. From the beginning, however, of efforts to eliminate international double taxation, another method has been chosen to delimit the taxation rights of states with respect to the profits of business-activities in more than one state. This method which is generally accepted by the international community of nations is the method of separate accounting, based on arm's length prices. This method was chosen in the first model conventions of the League of Nations as early as 1928, not only to avoid international double taxation but at the same time to attribute to separate taxing jurisdictions all the profits which may be considered to originate within each jurisdiction, not more, not less: the fair share for every taxing jurisdiction. In subsequent model conventions drafted in the OECD and the United Nations this choice has been reaffirmed. In the reports of the League of Nations already formula apportionment was rejected, and I quote, "because that method reaches results less true in the international context than those reached by the arm's length standard". Against the background of the almost universal acceptance of the separate accounting method, the use of worldwide unitary taxation by a number of states of the United States must produce results which only by coincidence can be more or less compatible with those of the separate accounting method.

Therefore the outcome of worldwide unitary taxation is **unfair** and **inequitable.**

The unfairness and inequity are not inherent in the method of formula apportionment, but they are inevitable, given the fact that internationally separate accounting based on arm's length prices is used by the overwhelming majority of nations. It is therefore that in our opinion the statement of the U.S. Supreme Court that the margin of error inherent in the method of unitary taxation is not greater than the margin of error inherent in the separate accounting method is so sad an error. Again, in theory, the one method has not necessarily greater intrinsic value than the other. Only they are uncompatible.

The third objection against unitary taxation is the fact that it amounts to extraterritorial taxation and requirements connected with taxation at variance with international law. Unitary taxation, in order to establish the worldwide income of the unitary business, has to demand annual reports of all companies included in the unitary business, irrespective of whether they conduct any business within the United States or not. Where the unity of a business is based on simple shareholding it can easily happen that the information requirements necessary for the application of unitary taxation in, for instance, the state of Alaska are applied to a company which operates solely in Africa. I can think of no better way to demonstrate the anomalies resulting from this method.

To simply imagine a number of states applying worldwide unitary taxation and consequently requiring all reports of the unitary business to be redrafted as many times as there are states applying the method, proves the impracticability of worldwide unitary taxation.

Now I would like to consider the relation between worldwide unitary taxation and international law. The most important instruments of international tax law are bilateral conventions for the avoidance of double taxation. The conventions concluded by the United States as a rule do not apply to taxes levied at state level but only to taxes levied by the federal authorities. Most conventions, however, contain some provisions which also relate to other taxes. In the OECD Model Convention of 1977 such a provision can be found in the so-called non-discrimination provision of article 24. This article, it is provided, applies to taxes of every kind and description. Article 24 forbids to subject nationals of a Contracting State to any taxation or to any requirement connected therewith which is other or more burdensome than the taxation or connected requirements to which nationals of the other State, in the same circumstances, are or may be subjected. The problem with unitary taxation is that to subject nationals or companies of other states to the same requirements as U.S. companies has the effect of subjecting the former to more burdensome requirements. U.S. law requires a parent company to report on income of its subsidiaries. The law of many other countries requires more or less equivalent information from parent companies resident in those countries. Under worldwide unitary taxation non-U.S. parents, however, are also required to report in the states of the U.S. applying unitary taxation on the income of non-U.S. subsidiaries determined in accordance with the law of those states although such subsidiaries do no business within the United States. So for foreign parent companies not only the law of their country of residence requires them to report on their subsidiaries as does U.S. law, but also the law of a state in which they operate through a subsidiary requires them to report on the worldwide business of the group.

Another kind of treaties which often contain some provision on taxation are agreements aimed at the mutual protection of investments. In the fifties the U.S. concluded a number of conventions of this type, also with the Netherlands. This "Convention of Friendship, Commerce and Navigation" from 1956 provides explicitly that the parties to it shall not impose on companies of the other party a tax on income, and I quote, "in excess of the income reasonably allocable or apportionable to their territories". As I have explained earlier, worldwide unitary apportionment will almost inevitably result in an amount of income being taxed at variance with the amount of income which would be attributed under separate accounting to a state. At the time of the conclusion of the FCN Treaty between the Netherlands and the United States the separate accounting method based on arm's length prices was already the generally accepted method of delimiting taxation rights between nations. In the suit brought by the Netherlands company Shell Petroleum N.V. against the California Franchise Tax Board the Netherlands Government therefore took the position in its briefs of amicus curiae that the use of unitary formula apportionment is at variance with the cited provision of article XI, paragraph 4. Attempts to obtain the opinion of the U.S. courts on this issue have failed up to now. Sooner or later, however, the Governments of the Netherlands and of the United States will have to decide on what in their opinion then is the meaning of this provision.

As to the relation between worldwide unitary taxation and international economic relations, the Netherlands Government has taken rather outspoken positions on several occasions. My Government has clearly expressed that it considers worldwide unitary taxation an impediment to international investment. The Netherlands, therefore, have perhaps been more fundamentally opposed to unitary taxation than some other countries. In our opinion, unitary taxation not only is unfair and inequitable for foreign investors in the United States but it also tends to dissuade U.S. investors from investment abroad, to the disadvantage of the U.S. economy as well. As the Netherlands Government firmly believes in the wholesome effects of international investment it has always advocated not just a so-called foreign parent solution but one which deals with all international relations on the same footing.

After having given you a gloomy picture of differences of opinion and of international controversy, now let us turn to the future and see whether the future holds promises for a brighter scene. The first event to catch our attention then is the draft-report presented just a couple of weeks ago to the Working Group headed by the Secretary of the Treasury, Mr. Regan. This report which is now being finalized and which will be submitted to the President by the end of this month must be considered the most important development of the last months of the scene of state taxation of multinational enterprises. Of course we have not yet had enough time to study the report thoroughly and besides it still is only a draft. Nevertheless we have noted with satisfaction that the Working Group unanimously recommends that the unitary method of taxation be limited to the so-called water's edge. Although this term might raise a few brows because of the way in which countries like Canada and Mexico are implicitly considered, we understand that the Working Group recommends to apply the unitary taxation mainly in domestic U.S. situations. In principle the Netherlands welcomes such a recommendation.

However it is still too early to declare victory. I note that the recommendation of the water's edge limitation has been made conditional by the state representatives in the Working Group on a solution of the foreign dividends question. Secondly: all the Working Group does, and all the President is expected to do is to *recommend* to the states that they limit their unitary taxation to the water's edge. Although a recommendation from the President may have great persuasive power it still leaves the decision and the timing to the addressees of the recommendation: the states.

Thirdly: the question of the treatment of foreign dividends not being resolved, unitary taxation remains a factor when considering from the U.S. investment abroad. And finally a lot of technical questions about the water's edge limitation and connected requirements remain to be answered before a comprehensive assessment of the situation can be made.

There are two points on which I would like to elaborate a bit more before concluding this speech. I would like to say a few things about the foreign dividends question and, what will probably interest you most, on the relation between the developments in the field of unitary taxation and the negotiations on the revision of the double taxation convention between the Netherlands and the United States. The question of the treatment of foreign dividends might at first sight be considered to be purely an issue of domestic taxation within the United States. For two reasons, however, I take the liberty to comment on the issue. First the fact that state representatives on the Working Group have declared to consider a satisfactory solution of this problem a condition to accept the water's edge limitation gives foreign countries an interest in the issue. Furthermore, as I have explained earlier, when foreign dividends are included in the basis for apportionment a comparison of the merits of investment in a foreign or in a domestic subsidiary is distorted by the application of the apportionment formula. This would tend to favour domestic investment which the Netherlands would regret.

Finally I come to the question of what will be the effect of the Working Group's report on the negotiations between the Netherlands and the United States on the revision of the existing double taxation convention. For this question as well it is too early to give a definite answer. Repeatedly the Netherlands have declared that the continued application of worldwide unitary taxation forms a serious obstacle to a successful conclusion of these negotiations. It will be clear that a recommendation, even where it be a recommendation by the President, to restrict the application of unitary taxation is in itself not sufficient to overcome such obstacle. For this obstacle to be overcome, more clarity is necessary about the way in which the states are going to react to the recommendation.

The same goes in sofar as cooperation with states in the field of exchange of information is concerned. In its position paper submitted to the Working Group the Netherlands Government has expressed its willingness to consider to lend the states access to information on transfer pricing exchanged between the Netherlands and the IRS. It must be clear that such a willingness applies only to states that renounce the use of worldwide unitary taxation.

When in the end all these questions have been answered in the positive, the last question we will have to ask ourselves is: are we satisfied with the result or do we want to consolidate it in any kind of formal agreement in order to make sure that unitary taxation may not be applied to our companies. Everyone present here, no doubt, will be aware of the fate of the U.S.–U.K. treaty provision in this respect. However, once states have accepted the water's edge limitation, such provisions should be acceptable to them.

Hong Kong's New Revenue Proposals and Their Implications

By Y.C. Jao

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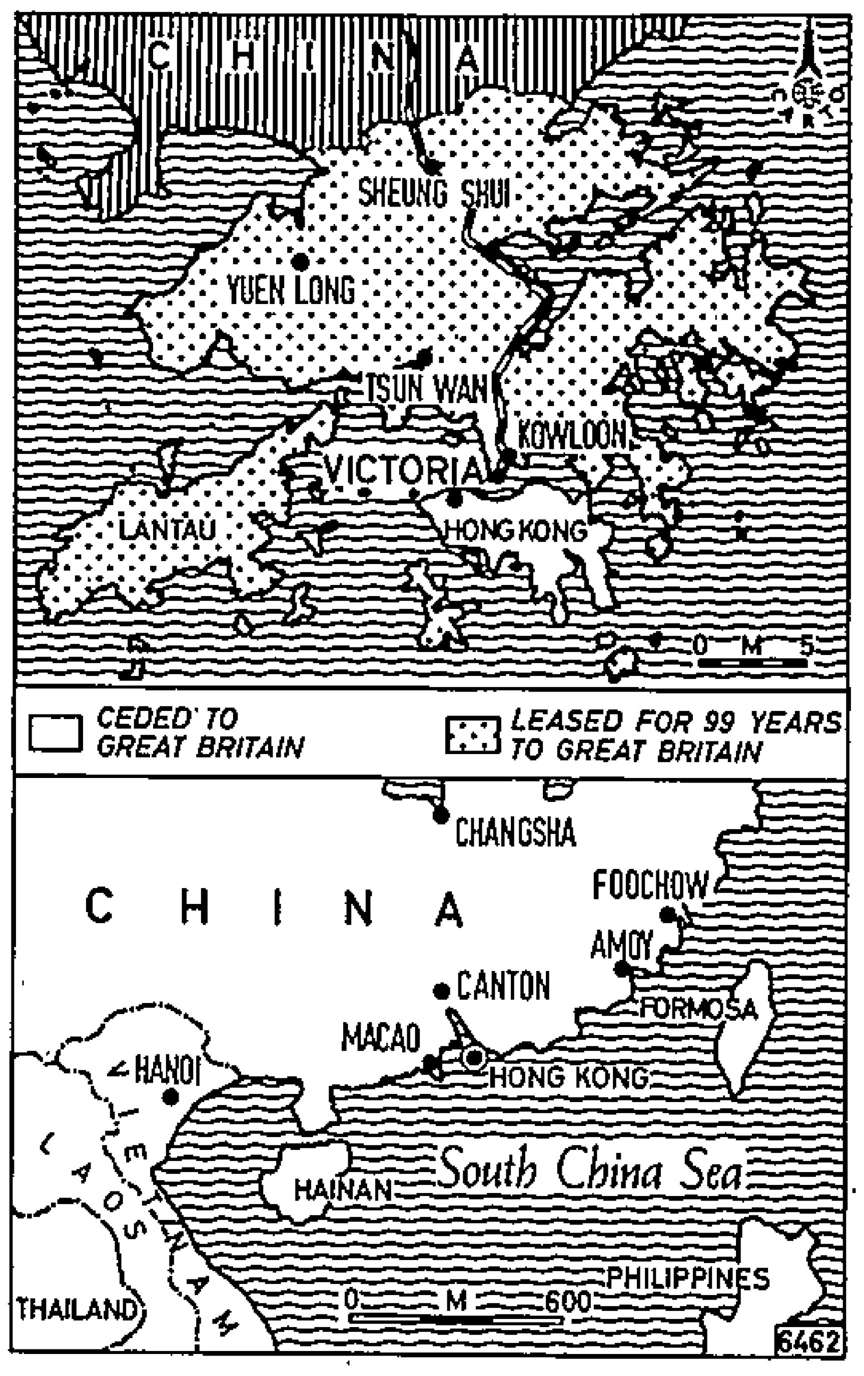

Hong Kong's 1984-85 Budget, presented on 29 February 1984 by the Financial Secretary, envisages another deficit of HK$3.6 billion. To cover this planned deficit, the Government resorts to a combination of fiscal devices: increasing taxes, borrowing, and drawing on fiscal reserves. This is the second consecutive fiscal year in which a deficit has been planned, and the third in which fiscal reserves have had to be depleted. In this article we will review the background for the continuing deficit, describe the measures taken to cope with it, and assess their macroeconomic consequences.

1. THE ECONOMIC BACKGROUND

Compared to a year ago, the general economic and political outlook of Hong in early 1984 appeared to have brightened. Although at the time of writing (late March 1984), the uncertainty over Hong Kong's future status has remained unresolved pending the outcome of the Sino-British diplomatic negotiations, the prevailing atmosphere has become somewhat calmer. Meanwhile, the Hong Kong economy has in the past year responded in its characteristically resilient manner to world economic recovery led by the United States. The real growth rate of Gross Domestic Product (GDP) in 1983 climbed to 5.9%, as against only 1.1% in 1982 and 4% in the Government's original forecast.[1] Export-oriented industries performed especially well, total exports (domestic exports plus-re-exports) having grown by an astounding 14.7% in real terms. The unemployment rate fell from 5.1% in the first quarter to 4.1% in the fourth quarter, while the inflation rate (as measured by the weighted average of three consumer price indexes), slowed down to 10% from 10.6% in 1982. The fall in the inflation rate would have been greater if the exchange rates of the Hong Kong dollar had been more stable.

This general improvement in the economy has occurred only after Hong Kong survived an excruciating financial crisis. During the first three quarters of 1983, the Hong Kong dollar depreciated continuously, as investors and depositors relentlessly switched out of Hong Kong currency denominated financial assets, in the face of the deepening gloom over Hong Kong's political future. The currency crisis came to a head on 24 September, when the exchange rate of the Hong Kong dollar against the U.S. dollar fell to an all-time low of US$1 = HK$9.6, representing a depreciation of 22% in barely 9 months. At that point, signs of a general financial panic became all too visible. Depositors not only desperately tried to switch from Hong Kong dollar deposits into U.S. dollar deposits; some of them even converted U.S. dollar deposits into notes, forcing some banks to suspend temporarily cash payment. Consumers began to stockpile foodstuffs and other staples, while some shops started quoting prices in U.S. dollars. Rumours also spread quickly about the financial difficulties of a number of banks.

Faced with this impending breakdown of the financial system, the Hong Kong Government, which hitherto had adopted a largely non-interventionist stance towards the monetary sector, was compelled to act swiftly. On 25 September it announced that a reform of the note-issue mechanism was under active consideration with a view to maintaining full convertibility and exchange rate stability. In the ensuing two weeks, the Government took over the management of a small domestic bank threatened with collapse, and joined in a rescue operation for another local bank. Then, on 17 October, a 2-point currency stabilization scheme was put into effect. Firstly, the two note-issuing banks, the Hongkong and Shanghai Banking Corporation and the Chartered Bank, were required henceforth to pay to the Exchange Fund foreign currency assets, at the fixed rate of US$1 = HK$7.8, in exchange for Certificates of Indebtedness, which, under the present monetary system of Hong Kong, constitute the legal backing for bank-notes. The main purpose of this measure was to impose a foreign exchange constraint on note issue, so that money supply would in future be determined largely by net external transactions. However, the new arrangement is technically a "linked rate exchange system", which differs from the traditional "fixed exchange rate system" in that it relies on the market process of "arbitrage and competition" rather than official intervention for the maintenance of exchange rate stability. Secondly, the controversial interest withholding tax on Hong Kong dollar deposits was abolished, a move obviously designed to reduce the "portfolio shift" from the domestic currency.

The new note-issue mechanism and linked exchange rate

1. Based on revised estimates of GDP following the availability of new information. See Census and Statistic Department, *Estimates of Gross Domestic Products 1966 to 1983,* Hong Kong, 1984.

system have so far proved to be highly successful as far as exchange stabilization is concerned. The exchange rate against the U.S. dollar since 17 October 1983 has fluctuated within 0.5% either way of the official rate. Fluctuations with respect to other currencies have been wider, but the trade-weighted exchange rate index has varied within a relatively narrow band of between 65.9 and 69.4 (18 December 1971 = 100).

With the currency and banking crises out of the way, at least for the time being, and on the reasonable assumption that the economies of the United States and other major Western countries, as well as China, will continue to recover, the Hong Kong economy was forecast to grow by 6.3% in real terms in 1984.

II. NEW REVENUE PROPOSALS

Since the fiscal year in Hong Kong begins on 1 April the Budget as presented at end-February was drawn up on the basis of 9 months' actual revenues and expenditures. However, the final deficit of the previous 1983-84 fiscal year was expected to be HK$3.32 billion, very close to the original estimate of HK$3.2 billion. All this deficit is being absorbed by fiscal reserves.

For the current fiscal year 1983/84, expenditures were estimated at HK$37.3 billion, and revenue at HK$33.7 billion, leaving a planned deficit of some HK$3.6 billion. This will be covered by (a) increasing tax revenue by HK$1.5 billion; (b) borrowing through the issue of HK$1 billion in Government bonds; (c) drawing down the fiscal reserves by HK$1.1 billion.

Before we discuss the revenue proposals in detail, it may be appropriate to make a general comment on expenditure cutting as a means to cope with fiscal deficit. Since the planned deficit amounts to less than 10% of total expenditure, in theory a cut-back in total expenditure averaging no more than 10% should be more than adequate to balance the budget. In practice, certain expenditure items, such as civil servants' salaries and benefits, have a built-in tendency to grow, and are not amenable to cut-backs. Expenditures on education, social welfare, public works, public housing, etc. are easier to manipulate. But it would be socially irresponsible and economically de-stabilizing if the burden of austerity were to fall entirely on such expenditures, especially at a time when the propensity to invest in the private sector is weak due to the uncertainty over Hong Kong's long term future. In other words, the Government must be seen to pursue a steady fiscal policy by continuing to invest in various infrastructural projects. To the credit of the Hong Kong Government, this is the course being taken. Despite the current fiscal difficulties, the growth of expenditures on public works, housing, education, social welfare, health is being maintained at an adequate but controlled rate.

Admittedly, during the 1970s, Government expenditures had tended to grow at a much faster rate than the GDP did, and this was a factor in the "overheating" of the economy, especially during 1978-81. The size of the public sector, measured by the ratio of total Government expenditure to GDP, rose from 12.9% in 1973-74 to 19.4% in 1982-83.[2] This rapid expansion was made possible partly by the sharp growth in land sales resulting from a booming property market. The Government can be fairly criticized for assuming that land sales could be relied upon as a sustainable source of revenue, so that when the property market collapsed in 1982 and land sales plummeted, Hong Kong was unceremoniously confronted with a large fiscal deficit. After strenuous attempts to restrain expenditure, the public sector size is now stabilized at 19.4%, according to the revised estimate for 1983-84, and is expected to fall to 18.3% in 1984-85.

The size and remuneration of the bureaucracy, however, remain a difficult problem in the structural deficit. Over the past two years, the growth of new posts in the civil service has slowed down, but this is the most the Government can do. In the current Budget, personal emoluments of civil servants and related expenses (mainly housing allowances) account for nearly 44% of recurrent expenditure. At the time of writing, the civil servants' unions are demanding a 11-13% rise in their salaries, but the current budgetary situation can only justify an upward adjustment of 9-11%.

Thus there is not much room for manoeuvre on the expenditure side. Any effective attack on the deficit has to come from the revenue side.

(a) Increased taxation

The Government proposes that HK$1.5 billion be raised through increased taxes, of which about HK$900 million will come from direct taxation, and HK$600 million from indirect taxation. This marks a departure from last year, when additional tax revenue was all derived from indirect taxes.

With regard to direct taxation, the two most important proposals are to raise the standard tax rate from 15% to 17%, and the corporation profit tax rate from 16.5% to 18.5%. The standard rate, which is applicable to salary tax, property tax, and profit tax on unincorporated businesses, was last adjusted upwards to 15% in 1966-1967. The corporation profits tax rate went through several changes in the past decade: it was raised from 15% to 16.5% in 1975-76, further increased to 17% in 1976-77, and then reduced to 16.5% in 1980-81.

These increases in basic tax rates have naturally attracted most attention, but two other measures may have no less important consequences for the tax system. One is the protection of profit tax yields from possible exploitation of loopholes resulting from the removal of the interest withholding tax. As mentioned earlier, in October 1983 the remaining 10% interest withholding tax on domestic currency denominated deposits with financial institutions in Hong Kong was abolished as part of the currency stabilization scheme. Prior to that, the withholding interest tax on foreign currency deposits was abolished effective from 25 February 1982. Because of these changes, there is a real risk that the profit tax base might be eroded through tax avoidance devices involving mainly the use of high debt-to-equity capitalization arrangements, and the placing of borrowed funds with fi-

2. These ratios are again based on revised GDP estimates.

nancial institutions in the form of deposits. Accordingly, the Financial Secretary proposes that, for profits tax purposes: (i) effective from 1 April 1984, the deduction of interest and related expenses in respect of borrowings from financial institutions will be prohibited where the moneys borrowed are secured or guaranteed, in whole or in part, against deposits made with a financial institution by a closely connected person; (ii) the deduction of interest and related expenses in respect of borrowings will be prohibited where the moneys borrowed, in respect of which the interest and related expenses are paid, are made available outside Hong Kong.

For the purposes of these prohibitions, "closely connected persons" are defined to include the proprietors of unincorporated businesses and their close relatives and associated corporations of limited liability enterprises, and "financial institutions" are defined to include financial institutions carrying on business in Hong Kong or abroad. The other measure relates to the treatment of interest income as part of business profits. In the past, the criterion used by the Inland Revenue Department for determining whether interest income is subject to profits tax is the "provision of credit text", i.e. the place where the money is made available to the borrower. While this test may still be valid for determining the liability of individual depositors, it has become less and less useful for determining the tax liability of businesses in an age of rapid technological and financial innovations, when large sums of moneys are lent as part and parcel of a business carried on in Hong Kong. Consequently, the Financial Secretary proposed that, again with effect from 1 April 1984, sums received or accruing by way of interest to businesses carried on in Hong Kong shall be chargeable to profits tax, irrespective of the currency in which the transaction is denominated and notwithstanding that the moneys in respect of which the interest is received or accrued are made available to the borrower outside Hong Kong. Since this proposal applies only to interest accruing on or after 1 April 1984, the addition to revenue will not come about until after 31 March 1985.

Increased yields from indirect taxation will come from higher betting duty (ranging from 0.5 to 3 percentage points on various bets and lotteries), rates (up to a maximum increase of 20%), and wine and spirits duty. Those from fees and charges include higher buoy and anchorage fees, registration and licence fees for deposit-taking companies (DTCs), and tunnel tolls and taxes. For more details, the reader is referred to Appendix A.

(b) Borrowing

The last marketable bonds of the Hong Kong Government were issued in 1975 also for covering a fiscal deficit. With a total value of HK$250 million and a maturity of 5 years, these bonds were repaid in 1980. Bonds issued prior to 1975 had also been redeemed, so that, at the end of 1983, there was no marketable Government debt. The only direct Government debt now outstanding is a non-marketable loan facility from the Asian Development Bank originally totalling HK$250 million.

In the fiscal year 1984-85, bonds totalling HK$1 billion will be issued by tender to the public. According to the Financial Secretary, the bonds will be fixed-rate Hong Kong dollar denominated bearer bonds, with a term of 5 years and a face value of HK$50,000. The last issue in 1975 was over-subscribed by financial institutions, and given that Hong Kong is now a much more sophisticated financial centre, there is no reason why the proposed new issue will not be equally welcomed, especially as the bonds will qualify as "specified liquid assets" under the existing Banking Ordinance and Deposit-taking Companies Ordinance.

(c) Drawing on fiscal reserves

With the additional revenue raised from increased taxes and fees, and the issue of bonds, the budgeted deficit is reduced to about HK$1.1 billion, which is to be covered by fiscal reserves. Such reserves have been built up in the past from realized fiscal surpluses. After allowing for contingent liabilities, such as, for example, Government guarantee of the debt of public corporations or projects like the Mass Transit Railway Corporation and the Home Ownership Scheme, "free" fiscal reserves available for disposal are estimated at HK$8.2 billion as of 1 April 1984. Assuming that the outturns of the 1984-85 expenditures and revenues are as estimated, the implied "free" fiscal reserves as at 1 April 1985 will be about HK$7.1 billion.

III. ASSESSMENT

Given that there are severe limits to expenditure-cutting without damaging effect on the economy, a combination policy of increasing taxation, borrowing, and drawing on fiscal reserves is, on the whole, the most realistic, or the least harmful way to tackle the deficit. This does not mean, however, that there are no problems in this approach, or that marginal adjustments cannot be made in the relative mix of the policy ingredients.

To begin with the tax proposals first, while some upward adjustment in direct taxation has been widely expected, especially as last year's tax increases were entirely on indirect taxes and fees, the extent of the increase in tax rates, namely, 2 percentage points in the standard rate and corporation profits tax, has nevertheless caused considerable dismay. It is widely felt that, at a time when capital formation in the private sector is weak, due to uncertainty over Hong Kong's future, a 2 percentage point rise in direct tax rates will act as a further disincentive to real investment. There is also concern that the standard rate, being applicable to salary tax, will hit the "sandwiched class" – the middle-income groups – harder than the very poor, who are not caught in the tax net, and the very rich, who have plenty of tax-planning devices to escape or avoid the higher tax burden.

To prevent possible abuse resulting from abolition of the interest withholding tax on domestic currency deposits, a number of loophole-plugging measures have been announced, as described in the previous section. At present, new legislation has yet to be passed to incorporate the proposed reform. However, as reported in the Hong Kong press, tax lawyers and other tax-avoidance specialists are already busy at work advising their clients how to get around the proposed prohibitions.[3] Many critics doubt whether the Government can effectively plug the loopholes without making the tax system much more complicated, in which case two attractive features of Hong Kong's existing tax system, simplicity and comprehensibility, will be lost.

Much more disturbing, to some observers, is the proposal to extend the ambit of profit tax by including interest income earned by or accrued to business carrying on in Hong Kong irrespective of the currency in which the transaction is denominated and the place in which the original loan or credit is made. In essence, this amounts to an acceptance of the general recommendation of the 1976 tax reform commission, the Third Inland Revenue Ordinance Review Committee, that profits tax should extend to profits made by a business actively carried on in Hong Kong without the substantial intervention of any branch anywhere.[4] This recommendation was not accepted fully by the Government due to practical difficulties in implementation, though specific targets have been selected and defined periodically to enlarge the scope of the profit tax charge. One of these was net interest income derived by a bank or financial institution based in Hong Kong from funds lent or invested overseas, which was brought within the tax net with effect from the fiscal year 1978-79.[5] Now, the Government apparently thinks that the time is ripe for charging to profits tax interest income received by non-financial business firms as well. While the Government is probably justified in arguing that the locality of the business carried on, rather than the physical location of the money lent, is the true source of the resultant interest income, some critics fear that the latest move might be interpreted by the business community, especially multinational corporations, as an infringement on the "territorial source" principle, to which the Hong Kong tax system supposedly adheres.[6]

Hong Kong's tax increases also took place at a time when its arch-rival, Singapore, did the opposite. In Singapore's Budget delivered on 2 March, a series of tax incentives and tax cuts was announced: extension of accelerated depreciation to all new equipment, investment allowances of up to 50% to local companies, extension of existing tax exemptions for offshore syndicated loans to other syndications of guarantees, performance bonds, etc., granting of a 5-year tax holiday to the proposed financial futures market, a 10% tax rebate to individuals in the year of assessment 1984, and tax cuts ranging between 8.4% to 13.5% for various income brackets in the year of assessment 1985. Earlier, in keen competition with Hong Kong for the position of leading financial centre of the Asian-Pacific region, Singapore lowered the tax rate on offshore profits of banks and financial institutions from 40% to 10% in March 1978. Then in September 1983, two more tax incentives were unveiled: fees earned by offshore banks on investment management would be taxed at 10% instead of at the normal corporate tax rate of 40%, and income earned by non-residents from funds managed by Singapore companies would be tax exempt.

IV. CONCLUSION

In my article published last year in this *Bulletin,* I said that "the halcyon days of chronic fiscal surplus for Hong Kong are over. A long period of difficult decisions and challenges awaits fiscal policy-makers".[7] The Budgetary exercise for 1984-85 illustrates once again the acute dilemma confronting the Hong Kong Government. On the one hand, fiscal exigencies require that tax rates be raised and loopholes be plugged through more elaborate regulations and restrictions. On the other hand, macroeconomic considerations demand that tax rates be kept as low, and the tax system as simple and comprehensible, as possible. The current 1984-85 Budget represents a skilful compromise between these conflicting goals. But its long term consequences remain uncertain.

3. *Asian Wall Street Journal,* 9-10 March 1984; *South China Morning Post,* 13 March 1984.
4. See Y.C. Jao, "Tax Reform and Fiscal Policy in Hong Kong", *31 Bulletin for International Fiscal Documentation* 4 (1977), 175-84; Y.C. Jao, "Tax Changes and Reforms in Hong Kong", 35 *Bulletin for International Fiscal Documentation* 8-9 (1981), 401-407.
5. See Y.C. Jao, "Hong Kong's New Tax On Offshore Banking Profits", 33 *Bulletin for International Fiscal Documentation* 1 (1979), 15-18.
6. Under the "territorial source" principle, only income "arising in or derived from" Hong Kong is chargeable to tax.
7. 37 *Bulletin for International Fiscal Documentation* 6 (1983), 265.

[For appendix, see overleaf]

APPENDIX A

Proposed changes in taxes and fees in Hong Kong's 1984-85 Budget

Category	Proposed changes
DIRECT TAXATION	
Standard rate of tax	Raised from 15% to 17%
Corporation profits tax rate	Raised from 16.5% to 18.5%
Profits tax	(a) Deduction of interest and related expenses prohibited if the moneys borrowed are secured or guaranteed against a deposit made with a financial institution by a closely connected person, or if the moneys borrowed are made available outside Hong Kong. (b) Interest income received by or accruing to business carried on in Hong Kong to be chargeable to profit tax, irrespective of the currency denominated and the geographical source.
INDIRECT TAXATION	
Betting duty	(a) Duty on standard bets increased from 8.5% to 9%. (b) Duty on exotic bets increased from 13.5 to 15%. (c) Duty on lotteries increased from 27% to 30%.
Rates	(a) The General Rate percentage reduced from 13.5% to 5.5% on the revised rateable values (about 3-4 times higher). (b) Maximum increase in annual payment of Rates limited to 20%. (c) Minimum rateable value set at HK$1,000 per annum. (d) 15% reduction in Rates payable for tenements without fresh water supply, and 7.5% reduction for those with an unfiltered supply.
Wine and spirits	Uniform reduction of about 10% in the current specific rate per litre, plus a uniform imposition of ad valorem rate of 20%, on European-type wines and spirits.
FEES AND CHARGES	
Buoys and anchorage	Daily fee for Class "A" buoys increased from HK$1,500 to HK$2,000; that for Class "B" from HK$1,000 to HK$1,400. Daily in-harbor anchorage fee increased from HK$14 to HK$28, and other charges from HK$4 to HK$8.
Deposit-making companies	Annual registration fee increased from HK$30,000 to HK$45,000; licence fee from HK$100,000 to HK$150,000; fee for local branch from HK$5,000 to HK$7,500; fee for overseas branch from HK$10,000 to HK$15,000; fee for overseas representative office from HK$5,000 to HK$7,500.
Licensed banks	Annual fee for local representative office increased from HK$10,000 to HK$15,000; fee for overseas branch from HK$20,000 to HK$30,000; fee for overseas representative offices from HK$5,000 to HK$7,500.
Lion Rock Tunnel	Tolls raised from HK$1.5 to HK$2 for small lorries, light buses and single-decker buses; from HK$1 to HK$2 for private cars.
Cross Harbour Tunnel	A tax of HK$ 2 for motor-cycles, and HK$5 for private cars, taxis, private light buses, and all goods vehicles.

CONFERENCE DIARY

AUGUST 1984

Asian-Pacific Tax & Investment Research Centre: Training Course on "Current Issues in Taxation and Investment in ASEAN countries". Singapore, 30 July-4 August (English).

National University of Singapore: Singapore Conferences on International Business Law (Conference 2: current issues in international financial law) (sponsored by the Development Bank of Singapore Ltd.) (including: islamic banking and finance; general contractual issues (taxation implications); bond issues; syndicated loans). Singapore, 15-18 August (English).

SEPTEMBER 1984

International Bar Association: Twentieth Biennial Conference (including: measures against treaty shopping; important new developments in national tax legislation as well as current activities of international organisations in the tax field; residence and transfer of residence of bodies corporate). Vienna (Austria), September 2-7 (English).

Commonwealth Association of Tax Administration (CATA): Technical Conference 1984 (including: incentives in tax systems for (a) economic, (b) social objectives). Apia (Western Samoa), 6-12 September (English).

International Tax Planning Association: Monte Carlo Workshop. Monte Carlo Workshop (including: foreign investment in French real estate – the new rules; decontrolled investment companies – a convenient marriage of U.S. and European investors; non-domiciled individuals working in the U.K.; the new rules, etc.). Monte Carlo, 13 and 14 September (English).

The Bureau of European Taxation & Trade: Double taxation relief in Europe (symposium). London (United Kingdom), 24 September (English).

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina), 16-21 September (English, French, German, Spanish).

OCTOBER 1984

Asian-Pacific Tax & Investment Research Centre: 2nd Asian-Pacific Tax Conference. Singapore, 16-17 October (English).

University of Miami: 39th Annual University of Miami Tax Conference. Miami (U.S.A.), 15-19 October (English).

Annual meeting of the German Tax Law Association: Basic international tax problems. Heidelberg (Federal Republic of Germany), 8-9 October (German).

NOVEMBER 1984

International Tax Planning Association: Hong Kong Seminar. Hong Kong, 26 and 27 November (English).

Legal Studies & Services Ltd.: 101 Inland Revenue Practices and Concessions. London (United Kingdom), 30 November (English).

[Continued on page 304]

Stamp Duties

A Case for Their Abolition

By H.W.T. Pepper

Stamp duties are one of the oldest surviving forms of taxation, having been introduced nearly 300 years ago in England (in 1694) and in earlier days the yield was relatively material.

The imposition of stamp duties in the then American colonies as a means of financing a defensive war was one of the reasons for the American War of Independence, which started in 1775, although the duties still survive in most American States. There are various reasons for the survival of such duties, although the yield today is relatively insignificant: in Great Britain the duties produce 0.8% of total revenue; in OECD countries the average yield is 1.7% of total revenue.

There are a number of reasons for survival, such as:

(a) taxpayers have become used to the duties which have existed a long time, and some of which are trivial. It is said that "an old tax is no tax" and Governments are therefore reluctant to abolish non-controversial sources of revenue;

(b) there is often an impression that the duties give legal authenticity to the stamped document (see below);

(c) because of the smallness of many of the levies, Governments and Finance Ministries often do not give much attention to them, being more concerned with majore revenue-producing taxes, even though there are many anomalies and transactions are often delayed by the stamping process.

MECHANICS OF DUTY COLLECTION

Originally most dutiable documents were embossed with duty payable as an acknowledgement of payment. This was done by machines which gradually became more and more sophisticated, in that they recorded the duties embossed and kept a running total of them. Individual embossing of documents is still a major method of a collecting stamp duty.

Postage stamps were "invented" in 1840 and eventually used to "stamp" duty on minor documents such as receipts, a practice which still survives in some countries. Specially printed revenue stamps also came into use as an alternative to taking or posting documents to a stamping office.

In some American States, postal meters were used to apply adhesive stamps acknowledging the duty paid. This was obviously quicker than assembling a collection of postage stamps to make up the value required, but the need to re-charge the meters daily, or more frequently, proved tedious. The next stage was to rubber stamp the document and endorse the stamp impression with the value in writing of the payment and a reference to the register number where the transaction is recorded.

The greatest time-saving is, however, effected by compositions whereby the payers, such as financial institutions, lawyers, and stockbrokers, are permitted to use documents pre-printed "duty paid" and record dutiable transactions and remit the accumulated duty in monthly or more or less frequent instalments. The records are, of course, subject to audit, but the time-saving factor is so important that those who have made compositions are unlikely to try to defraud the revenue authorities.

In some cases of trivial duties, such as the levy of a cent or two on air waybills used by foreign and local airlines, it may be better and simpler to levy a customs or an excise duty on the blank forms at the moment of importation or manufacture to replace the stamp duty.

SANCTIONS ON COLLECTION

It is usual to lay down the rule that dutiable documents may not be used in evidence in Civil Court actions unless the stamp duty has first been paid. There are usually saving provisions, however, enabling late payment to be made (plus some level of penalty), a reasonable policy although it may encourage those who do not expect to be involved in Court action to gamble on not paying the stamp duty.

More important sanctions are the rule that real property will not be registered in the name of the buyer unless evidence of payment of duty on the transaction is produced.

ANOMALIES

There are some curious "take and give" cases in some countries' fiscal patterns, involving stamp duties imposed a long time ago. For example, in Great Britain, a stamp duty on life assurance policies still survives, but on the other hand, tax relief on the premiums paid was introduced in the 19th century by Gladstone's Government. The relief has now been converted to a 15% discount on premiums even for those taxpayers who are below the taxable limit for income tax. Since the duty on the policy is obviously passed on to the customer, the taxpayer is faced initially with a minor bill for duty and later is given a handsome State subsidy on his premiums!

Some countries levy a duty on purchases of residences, and on the mortgage documents, but then allow tax relief for the payment of mortgage interest (incidentally giving the house buyer an advantage over those too poor to buy, who receive no relief or subsidy for the rent they have to pay to their landlords!).

Some countries still levy stamp duty on receipts, although, strictly speaking, a Government should encourage the issue of receipts, rather than tax them! When it was realised that payment by cheque provided the payer with evidence of payment in the form of the cancelled cheque returned to him by his bank, this removed the need for obtaining a receipt. In Ireland the Government reacted by increasing the stamp duty on cheques because of the dual role they now played.

Some countries still impose duty on cheques, but also on those who draw money from their savings accounts at banks. The person with a cheque book may pay bills and make purchases by using cheques and does not have to visit his bank. The person with a savings account has to spend time and money on transport to visit his bank to draw money from his own savings. Some financial institutions in the same countries do not insist on receipts for withdrawals, but merely make an entry in the passbook. There are thus considerable anomalies between different taxpayers.

In many countries there are not only stamp duties on contracts and other legal instruments but also transfer taxes on transfers of ownership of real property, stocks and shares, etc., the latter usually being much more material. There is usually a case for amalgamating the two levies into a single one to reduce administrative work and collection costs.

ABOLITION OF STAMP DUTIES

There is clearly a case for abolishing stamp duty as a separate levy. One factor in its survival is that there is no political weight for abolition. In a way, it is better to have a number of taxes, none of which is in itself particularly oppressive. If minor taxes are abolished and "rolled up" into other taxes, this increases the weight of the others and increases their unpopularity.

The linking of stamp duties with the legality of documents for evidence in civil Court cases is slightly misleading because the document is not necessarily less competent because of the absence or delay of duty payment. The invalidity sanction is merely a means of enforcing duty payment.

A considerable amount of work would be necessary to consolidate stamp duties with others, or change them into other forms of tax, but especially where the total yield is small, it is necessary to grasp the nettle and proceed.

In Great Britain the annual stamp duty yield is about 1,000 million pounds, so the duties cannot be lightly cast aside. A "bonfire" of minor duties was held some years ago when duties on receipts and cheques, etc., were abolished. The remaining duties are, however, under review and there are a number of anomalies which perhaps could do with early removal.

Where the private sector and the Government are both involved in the administration and collection of minor levies, it is not always easy to assess the total cost. Recently, in Great Britain it has been calculated that the revenue from the licensing of the dog population (running into some millions) – entirely operated by Government – produces a *negative* revenue of about three million pounds a year. The licence fee (not a stamp duty) has remained at £ 0.375 for many decades. It is, of course, necessary to maintain a licensing system so that stray dogs can be rounded up. There are political reasons for having a low licence fee since the poor, the aged, and blind persons keep dogs as companions and guides. The fees are not intended as a source of revenue, but registration is essential and a moderate increase in the licence to cover administration costs may eventuate.

In the case of old stamp duties which serve no useful purpose and are costly to collect there are, of course, strong reasons for abolition.

CONCLUSION

In many countries there is scope for:

(a) abolition of trivial stamp duties; and
(b) making compositions in respect of other duties to reduce administrative costs, and avoid delay in completing transactions that are subject to stamp duty;
(c) where stamp duties are worthy of continuance no change in the rate of duty may be necessary where it is on an ad valorem basis, but fixed duties should be reviewed as a minor budgetary exercise to increase duties in step approximately with movements in the price index;
(d) because of the reasoning that "an old tax is no tax", the more remunerative duties should be retained subject to the streamlining procedure mentioned in (b), and rather than abolition of the old duty which involves introducing a new tax or increasing an old one to replace lost revenue.

[Continued from page 302]

DECEMBER 1984

U.K. Tax Congress Ltd.: 4th Annual U.K. Tax Congress; 1984 Developments & Finance Act (including transfer pricing, golden handshakes, share options and incentives, trading losses and withholding taxes). London (United Kingdom), 6-7 December (English).

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German Tax Law Association (Deutsche Steuerjuristische Gesellschaft), Postfach 52 04 29, 5000 Cologne 51, Federal Republic of Germany.

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The Zimbabwe 1983 Budget

By D.G. Murphy

The Minister of Finance, Economic Planning and Development, Dr. Bernard Chidzero, announced his proposed taxation measures to the House of Assembly on 28 July 1983. Most of the measures announced were enacted in the Finance (No. 2) Act 1983, No. 32 of 1983, which was promulgated on 25 November 1983. There was some delay in drafting the legislation to cover the new lower level employees' tax which was finalised in the Finance Act 1984, No. 7 of 1984, promulgated on 23 March 1984.

RATES OF TAX

Income tax comprises tax at basic rates plus a surcharge. No change was made to the basic rates of tax. However, the rate of surcharge for companies for the year ended 31 March 1982 (15%) was increased to 20% for 1982/83 but reverts to 15% thereafter. The maximum rate of income tax for companies thereby increased from 51.75% to 54% for 1982/83 whilst foreign companies remain additionally subject to branch profits tax at the unchanged effective rate of 8.4%. The rates of surcharge for other taxpayers for the year ended 31 March 1983 which ranged from 15%, on basic tax chargeable of $ 4,000 or less, to 33⅓%, on basic tax chargeable of over $ 12,000, were increased to range from 20% to 40% for 1983/84 but revert to the 1982/83 rates thereafter. The full tables of these rates of surcharge are:

Basic tax payable Z$	Z$	Surcharge 1982/83 Z$	1983/84 Z$	Z$
0 -	4,000	15%	20%	
4,001 -	5,000	600 + 16%	800 + 21% of excess over	4,000
5,001 -	6,000	760 + 17%	1,010 + 22% of excess over	5,000
6,001 -	7,000	930 + 18%	1,230 + 24% of excess over	6,000
7,001 -	8,000	1,110 + 20%	1,470 + 26% of excess over	7,000
8,001 -	9,000	1,310 + 22%	1,730 + 28% of excess over	8,000
9,001 -	10,000	1,530 + 24%	2,010 + 31% of excess over	9,000
10,001 -	11,000	1,770 + 27%	2,320 + 34% of excess over	10,000
11,001 -	12,000	2,040 + 30%	2,660 + 37% of excess over	11,000
12,000 and over		2,340 + 33⅓%	3,030 + 40% of excess over	12,000

The maximum rate of income tax for taxpayers other than companies thereby increased from 60% for the year ended 31 March 1983 to 63% for 1983/84.

Part of this increase in surcharge for 1983/84 is collected in advance. An advance surcharge of 5% is added to basic tax raised in the 1982/83 notice of assessment in so far as it relates to taxable income but subject to PAYE.

Mr. D.G. Murphy is lecturer in taxation at the University of Zimbabwe, and tax consultant to Peat, Marwick, Mitchell & Co., Harare, Zimbabwe. See for a discussion of the Zimbabwe tax system, Mr. Murphy's article: "Zimbabwe: A survey of its Tax System" in 37 BIFD (1983) at 27 and 145

The advance surcharge is credited in the 1983/84 notice of assessment.

The following table shows income tax payable by individuals at selected levels of taxable income:

Taxable income $	Income tax payable (including surcharge): Single person 1982/83 $	Single person 1983/84 $	Married person with no children 1982/83 $	Married person with no children 1983/84 $	Married person with two children 1982/83 $	Married person with two children 1983/84 $
4,000	474	494	184	192	Nil	Nil
8,000	1,624	1,694	1,150	1,200	966	1,008
12,000	3,142	3,278	2,484	2.592	2,300	2,400
16,000	5,049	5,268	4,186	4,368	4,002	4,176
18,000	6,095	6,360	5,197	5,423	5,012	5,230
20,000	7,151	7,462	6,245	6,516	6,058	6,321
22,000	8,214	8,580	7,302	7,621	7,113	7,422
24,000	9,294	9,714	8,368	8,741	8,176	8,539
28,000	11,506	12,041	10,549	11,030	10,353	10,824
32,000	13,803	14,464	12,807	13,412	12,602	13,198
36,000	16,189	16,972	15,160	15,891	14,947	15,667
40,000	18,589	19,492	17,560	18,411	17,347	18,187
50,000	24,589	25,792	23,560	24,711	23,346	24,487
60,000	30,589	32,092	29,560	31,011	29,346	30,787
70,000	36,589	38,392	35,560	37,311	35,346	37,087

NEW TAXES INTRODUCED

1. Non-residents' tax on fees (NRTF)[1]

This is a withholding tax levied at the rate of 20% on fees payable to a non-resident, including a partnership, on or after 29 July 1983.

The term "fees" is defined to mean any amount from a source within Zimbabwe in respect of any service of a technical, managerial, administrative or consultative nature. Fees payable by a resident of Zimbabwe are deemed to be from a source within Zimbabwe. A partnership is treated as resident in Zimbabwe if at least one partner is ordinarily resident in Zimbabwe.

The term "fees" does not include amounts payable in respect of: services unconnected with the payer's business affairs; services rendered by employees of the payer (but directors' fees are subject to NRTF): education or technical training; the repair of goods outside Zimbabwe; and projects exempted by the Minister or by the terms of an agreement entered into by the Government with another Government or international organisation.

NRTF must be paid over to the Department of Taxes within 30 days of the fees being paid or becoming owing to the non-resident payee.

Should the recipient of fees suffer both Zimbabwe in-

1. *Editor's note*: See for tax treaty articles discussed the Appendix to this article.

come tax and NRTF in respect of the fees, machinery exists for the allowance of double taxation relief.

The wording of Article 24(2) of the Double Taxation Agreement (DTA) with the United Kingdom would appear to provide exemption from NRTF in respect of fees receivable by a non-resident permanent establishment of a U.K. enterprise. However in these early days of the new NRTF legislation it is understandable that no general procedure exists for conferring the exemption. Until such a general procedure is established applications will have to be made on an individual basis. The tax authorities of the two countries may use the "mutual agreement procedure" provided in Article 25 to settle the application of Article 24(2). Of course an applicant who is denied an exemption under Article 24(2) can pursue the matter independently using the rights of appeal granted under the legislation. It would be prudent of any applicant for exemption to ensure that these rights are not allowed to lapse.

Fees receivable by a U.K. resident and unconnected with a permanent establishment in Zimbabwe cannot be subject to an amount of Zimbabwe tax which exceeds 10% of the gross fees. This limitation of Zimbabwe tax is found in Article 13(2) of the DTA which applies if the fees are "technical fees" as defined therein and are subject to U.K. tax. The recipient of such fees should ask the local tax authorities to authorise the deduction of NRTF at the rate of only 10%. No other Zimbabwe tax is leviable if the fees are subject to Article 13(2). Relief from double taxation is provided by the U.K. under Article 23 of the DTA.

The DTA with the Republic of South Africa (R.S.A.) goes back to 1963/64 when no withholding taxes were levied by Zimbabwe (then Southern Rhodesia). The DTA does not specifically mention withholding taxes and "profits" is defined to mean taxable income, a term used in relation to income tax. But it does state that it applies to all other taxes (besides income tax) on persons or on the income of persons and to all other taxes of a substantially similar character imposed after the signing of the DTA. Also, it is a fact that in practice the withholding tax levied by R.S.A. on dividends, NRST, was and still is treated as a tax for the purposes of the DTA as, it would appear, is the later withholding tax imposed by R.S.A. on interest. It would therefore appear that all withholding taxes levied by Zimbabwe are taxes for purposes of the DTA.

Article IX of the DTA grants exemption from Zimbabwe tax on profits or remuneration in respect of personal, including professional, services performed within Zimbabwe by an individual who is a resident of R.S.A. Three conditions have to be fulfilled before the exemption can apply. First, the individual's presence in Zimbabwe must not exceed 183 days in the tax year. Second, the services must have been performed for or on behalf of a resident of R.S.A. Third, the profits or remuneration must be subject to R.S.A. tax. (The exemption cannot apply to public entertainers or athletes).

Article III of the DTA stipulates that an industrial or commercial enterprise is exempt from Zimbabwe tax on industrial and commercial profits which are not attributable to a permanent establishment through which it is engaged in trade or business in Zimbabwe. The term "industrial or commercial profits" does not, inter alia, include income in the form of: any amount for the imparting of or the undertaking to impart any knowledge directly or indirectly connected with the use of any cinematograph or television films or any sound recording or advertising matter directly or indirectly connected therewith or with the use of any patent, design, model, plan, trade mark, copyright, secret process, formula or other property of a similar nature; management charges; remuneration for personal services.

If exemption is not conferred one must look to Article XIII to obtain relief for NRTF charged on fees which are also subject to S.A. tax. S.A. tax on profits from sources within S.A. is allowable, subject to the provisions of the Zimbabwe Income Tax Act, as a credit against Zimbabwe tax on the same profits. For the purposes of Article XIII profits or remuneration for personal, including professional, services performed in S.A. are profits from sources within S.A. Section 79(3) of the Act limits the credit to be allowed to the total tax chargeable under the Act. Whilst for NRTF purposes fees are given a Zimbabwean source if paid by a resident of Zimbabwe, the real source of the fees would determine the application of Article XIII. Reciprocal provisions are laid down whereby S.A. would grant a credit against its tax for Zimbabwe tax on profits from sources within Zimbabwe.

2. Non-residents' tax on remittances (NRTR)[2]

NRTR is levied at the rate of 20% on remittances of allocable expenditure made from Zimbabwe to another country on or after 29 July 1983.

The term "allocable expenditure" is defined to mean expenditure of a technical, managerial, administrative, or consultative nature incurred outside Zimbabwe by a non-resident, including a partnership, in connection with or allocable to the carrying on by the non-resident of any trade within Zimbabwe. The term "trade" is widely defined.

NRTR was introduced at the same time as NRTF and was officially described as being leviable on remittances of the external costs of certain services allocated to local branches. NRTR would appear to have been necessarily consequential following upon the introduction of NRTF. The latter covers fees paid by a payer to a payee and is not leviable upon mere transfers made by a branch within one organisation. The transfer, if it is made outside Zimbabwe and consists of allocable expenditure, is caught by NRTR. The combination of NRTF and NRTR deters the liquidation of local subsidiary companies and their conversion into branches for the purpose of avoiding NRTF.

If a local branch of a foreign enterprise reduces its taxable income subject to Zimbabwe income tax and, in the case of company, branch profits tax by a charge for, say, head office expenses which falls within the definition of allocable expenditure, NRTR of 20% becomes leviable if and when the head office expenses are remitted from Zimbabwe. The legislation does not provide for any re-

2. See note 1 above.

lief for the NRTR paid against any other Zimbabwe tax levied on the foreign enterprise's operations. If the branch had a loss for income tax purposes NRTR would still be leviable on the remittance.

The local branch may be making a remittance which consists of both profit and allocable expenditure. All remittances from Zimbabwe require approval under exchange control regulations administered by the Reserve Bank of Zimbabwe. The Reserve Bank would probably require certification to the effect that the allocable expenditure had sufferred NRTR. In the circumstances whatever appropriations were necessary, a split of the total remittance between profit and allocable expenditure would have to be made.

Articles 7(1) and 15 of the DTA with the United Kingdom limit Zimbabwe's right to taxation in respect of the business profits of a U.K. enterprise and the income of a U.K. resident from independent personal services. Zimbabwe can tax only the profits attributable to the local permanent establishment of the U.K. enterprise or to the local base of the U.K. resident. When the U.K. enterprise or U.K. resident allocates expenditure to the local permanent establishment or fixed base the result is to increase the external profit and to reduce the Zimbabwe profit. The allocation of expenditure made to the local permanent establishment or fixed base forms no part of the business profits or income of the permanent establishment or fixed base. The allocation of expenditure is in fact part of the external profit or income of the U.K. enterprise or U.K. resident. In the circumstances it would appear that the levy of NRTR on this allocable expenditure would contravene the DTA. It is added, merely as an aside, that it would be odd if a liability for a future tax, NRTR, were to arise from the very expenditure which the DTA itself directs, at Article 7(3), must be allocated to the permanent establishment. The term permanent establishment would include a fixed base. From the Zimbabwean point of view NRTR may appear to be solely a tax on remittances. But in the context of the DTA it is difficult not to see it as a tax on the profits of the U.K. resident or enterprise.

The DTA with the Republic of South Africa (R.S.A.) contains, at Article III, a similar restriction on Zimbabwe's right of taxation of a R.S.A. enterprise. The R.S.A. enterprise is subject to Zimbabwe tax on its industrial and commercial profits only to the extent that such profits are attributable to a permanent establishment through which the enterprise is engaged in trade or business in Zimbabwe. Under NRTF above it was pointed out that the definition of "industrial or commercial profits" excluded certain types of income. No income arises from the mere allocation of expenses to the permanent establishment. The allocation has to be made under Article III(4). In the circumstances the levy of NRTR would appear to be in breach of Article III.

Countries other than the U.K. and R.S.A. have no protection against the levy of NRTR since at present only these two countries have a DTA with Zimbabwe. Incorporation of a local branch into a company resident in Zimbabwe would remove the threat of NRTR. (A locally incorporated company would receive its fees free from any deduction of NRTF.) However the company would have to deduct NRTF from any fees which it paid if the payee of the fees was non-resident. The NRTF is deductible whether or not the fees are remitted from Zimbabwe.

There is nothing in the legislation which states that NRTF and NRTR are alternative forms of taxation. Apparently NRTF can be charged on the fees earned by a non-resident branch and NRTR can also be charged on the allocable expenditure remitted by the branch. A similar type of situation arose many years ago when NRST and branch profits tax, which discouraged the liquidation of local companies to avoid NRST, were introduced. The legislation was subsequently amended to exempt from NRST dividends distributed from profits which had been subjected to branch profits tax. It seems probable that a similar type of amendment will be evolved to avoid the double charge of NRTF and NRTR when practical examples of the problem have been presented and examined.

3. Lower level employees' tax (LLET)

LLET was introduced with effect from 1 April 1984. It is levied at the rate of 2% on remuneration payable daily, weekly, monthly or annually to employees, other than agricultural and domestic employees, provided the amount of the daily, weekly, monthly or annual remuneration is not less than $ 4.62, $ 23.08, $ 100 or $ 1,200, respectively, including the value of any free benefits enjoyed daily, weekly, monthly or annually, depending on how the employee is paid.

LLET is an alternative and separate form of income tax but no abatements (personal allowances) are granted for the purposes of LLET which is a straight 2% of the gross remuneration reduced only by the employee's contributions made to a group pension fund. Normal income tax, which grants the benefits of the abatements, is usually collected by deduction from remuneration under the PAYE system. Remuneration cannot suffer the deduction of both LLET and PAYE since only the latter is deducted when it is equal to or greater than LLET.

At the end of the tax year the employee's liability is to either LLET or normal income tax. If the liability for the year is to LLET it is quantifiable as the sum of the 2% of the daily, weekly, etc., remuneration which could have been deducted as LLET in the tax year. Amounts actually deducted as either LLET or PAYE are credited against the total liability, whether for LLET or normal income tax, for the year. Shortfalls of less than $ 10 and overpayments of less than $ 5 are ignored.

For LLET purposes an employee is an individual to whom remuneration is payable. A man and his wife are treated as separate employees. A director of a company who receives an annual director's fees of less than $ 1,201 could be subject to LLET.

There are some differences in the meaning of remuneration for LLET purposes and its meaning for the purposes of normal income tax.

OTHER INCOME TAX AMENDMENTS

(i) A training investment allowance (TIA) is deductible in respect of new training buildings and equipment for 1983/84 and subsequent tax years. The deduction is 50% of the cost of the new training buildings, additions and alterations thereto, and equipment. The deduction of the TIA is over and above any deduction available by way of any capital allowance that may be available for the cost itself and the TIA is not subject to any income tax recoupment on the disposal of the building or equipment.

(ii) The foreign dividends of Zimbabwe residents were made subject to income tax from 1981/82 and a special flat rate of 20% on the gross dividend was imposed. The law has now been amended, with effect from 1981/82, to ensure that such dividends do not reduce an assessed loss which is available for carry forward.

(iii) The deductible cost of a passenger motor vehicle purchased on or after 1 April 1984 was increased from $ 9,000 to $ 15,000. A similar increase was made for the total leasing cost of such a vehicle first leased on or after 1 April 1984.

(iv) The allowable deduction for the cost of successful income tax appeals was extended to short term insurers.

(v) Staff housing did not rank as such for the capital allowances if its cost exceeded $ 5,000. This figure was increased to $ 8,000 for staff housing the erection of which was recommended on or after 1 April 1984. It will no longer be possible for a purchaser of staff housing which cost more than $ 5,000/$ 8,000 to erect to claim the wear and tear allowance applicable to staff housing.

(vi) The exemption applicable to the allowances and free benefits of the Chief Justice can be extended to any judge of the Supreme or High Court and to the Ombudsman and Deputy Ombudsman.

(vii) The African Development Fund is exempt from tax and also declared exempt is the interest of the European Investment Bank and the interest of non-resident institutional shareholders on their loans to the Zimbabwe Development Bank.

CAPITAL GAINST TAX (CGT) AMENDMENTS

(a) When CGT was introduced on 1 August 1981 the 5% national cost deduction – or inflation allowance to overseas readers – could not create or augment an assessed capital loss. This restriction on its deduction has been removed with effect from 1 August 1981. The deduction has been made available in respect of mining assets but it has been withdrawn in respect of building society shares.

(b) Amounts arising by reason of the maturity or redemption of chargeable investments and by way of liquidation dividends are accountable for CGT purposes.

(c) The shares of non-resident institutional shareholders in the Zimbabwe Development Bank are exempt.

AMENDMENTS TO SALES TAX AND IMPORTS TAX

The rates of sales tax and imports tax of 15% on general goods and 19% on listed higher-rated goods were increased to 18% and 23%, respectively, from 1 August 1983 and the list of higher rated goods was extended.

CUSTOMS AND EXCISE DUTIES

A 15% customs duty on imported lorries and vans, in an assembled or unassembled state, was imposed from 29 July 1983 and the 15% surtax on imported goods was increased to 20% from the same date. A 15% excise duty on locally assembled passenger motor vehicles was also introduced on 29 July 1983.

APPENDIX

TAX TREATY BETWEEN SOUTH AFRICA AND ZIMBABWE (FORMER SOUTHERN RHODESIA)

. . .

Article III

(1) The industrial and commercial profits of an enterprise in one of the territories shall not be subject to tax in the other territory unless the enterprise is engaged in trade or business in the other territory through a permanent establishment in that other territory. If it is so engaged tax may be imposed on those profits by the other territory but only on so much of them as is attributable to that permanent establishment.

(2) Where an enterprise of one of the territories is engaged in trade or business in the other territory through a permanent establishment situated therein–

(a) there shall be attributed to that permanent establishment the industrial or commercial profits which it might be expected to derive in that other territory if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment;

(b) subject to the provisions of sub-paragraph (a), no profits derived from sources outside that other territory shall be attributed to that permanent establishment.

(3) No portion of any profits arising from the sale of goods or merchandise by an enterprise of one of the territories shall be attributed to a permanent establishment situated in the other territory by reason of the mere purchase of the goods or merchandise within that other territory.

(4) In determining the industrial or commercial profits of a permanent establishment there shall be allowed as deductions all ex-

penses which would be deductible if the permanent establishment were an independent enterprise in so far as they are reasonably allocable to the permanent establisment, including executive and general administrative expenses so deductible and allocable, whether incurred in the territory in which the permanent establishment is situated or elsewhere.

(5) This Article shall not apply in any case in which its application would have the result that income, which but for such application would be subject to tax in one of the territories, would not be subject to tax in either territory.

. . .

Article IX

(1) An individual who is a resident of South Africa shall be exempt from Southern Rhodesian tax on profits or remuneration in respect of personal, including professional, services performed within Southern Rhodesia in any year of assessment if–

(a) he is present within Southern Rhodesia for a period or periods not exceeding in the aggregate 183 days during that year; and

(b) the services are performed for or on behalf of a person resident in South Africa; and

(c) the profits or remuneration are subject to South African tax.

(2) An individual who is a resident of Southern Rhodesia shall be exempt from South African tax on profits or remuneration in respect of personal, including professional, services performed within South Africa in any year of assessment if–

(a) he is present within South Africa for a period or periods not exceeding in the aggregate 183 days during that year; and

(b) the services are performed for or on behalf of a person resident in Southern Rhodesia; and

(c) the profits or remuneration are subject to Southern Rhodesian tax.

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Article XIII

(1) Subject to the provisions of the law in Southern Rhodesia regarding the allowance of a credit against Southern Rhodesian tax of tax payable in South Africa, South African tax payable in respect of profits from sources within South Africa shall be allowed as a credit against any Southern Rhodesian tax payable in respect of such profits.

(2) Where Southern Rhodesian tax is payable in respect of profits derived from sources within Southern Rhodesia by a person ordinarily resident in South Africa, South Africa shall either impose no tax on such profits or, subject to such provisions, which shall not affect the general principle hereof, as may be enacted in South Africa, shall allow the Southern Rhodesian tax as a credit against any South African tax payable in respect of such profits

(3) For the purposes of this Article profits or remuneration for personal, including professional, services performed in one of the territories shall be deemed to be profits from sources within that territory, and the services of an individual whose services are wholly or mainly performed in aircraft or other transport vehicles operated by a resident of one of the territories shall be deemed to be performed in that territory.

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TAX TREATY BETWEEN THE UNITED KINGDOM AND ZIMBABWE

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Article 7
Business profits

(1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

(2) Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including an allocation of executive and general administrative expenses incurred for the purposes of the enterprise as a whole, whether in the State in which the permanent establishment is situated or elsewhere.

(4) Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph (2) of this Article shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

(5) No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise .

(6) For the purposes of the preceding paragraphs of this Article the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

(7) Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

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Article 13
Technical fees

(1) Technical fees arising in a Contracting State which are derived by a resident of the other Contracting State may be taxed in that other State.

(2) However, such technical fees may also be taxed in the Contracting State in which they arise, and according to the law of that State; but where such technical fees are derived by a resident of the other Contracting State who is subject to tax there in respect thereof the tax charged in the Contracting State in which the technical fees arise shall not exceed 10% of the gross amount in the technical fees.

(3) The term "technical fees" as used in this Article means payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any services of a technical, managerial or consultancy nature.

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Article 15
Independent personal services

(1) Subject to the provisions of Article 13, income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other State but only so much of it as is attributable to that fixed base.

(2) The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 23
Elimination of double taxation

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(2) Subject to the provisions of the law of Zimbabwe regarding the allowance as a credit

against Zimbabwean tax of tax payable in a territory outside Zimbabwe (which shall not affect the general principle hereof):

(a) United Kingdom tax payable, whether directly or by deduction, in respect of taxable income or chargeable gains from sources within the United Kingdom shall be allowed as a credit against any Zimbabwean tax computed by reference to the same taxable income or chargeable gains by reference to which the United Kingdom tax is computed.

(b) In the case of a dividend paid by a company which is a resident of the United Kingdom to a company which is a resident of Zimbabwe and which controls directly or indirectly at least 10% of the voting power in the company paying the dividend, the credit shall take into account (in addition to any United Kingdom tax for which credit may be allowed under the provisions of sub-paragraph (A) of his paragraph) the United Kingdom tax payable by the company in respect of the profits out of which such dividend is paid.

(3) For the purposes of paragraphs (1) and (2) of this Article profits, income and capital gains owned by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources in the other Contracting State.

Article 24
Non-discrimination

(1) Nationals of a Contracting State shall not be subject in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

(2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. Provided that this paragraph shall not prevent a Contracting State from imposing on the profits attributable to a permanent establishment in that Contracting State of a company which is a resident of the other Contracting state a tax not exceeding 2½% of those profits in addition to the tax which would be chargeable on those profits if they were profits of a company which was a resident of the first-mentioned State.

(3) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subject in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected.

(4) Except where the provisions of paragraph (1) of Article 9, paragraph (8) of Article 11, paragraph (6) of Article 13 apply, interest, royalties, technical fees and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

(5) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not resident in that State any of the personal allowances, reliefs and reductions for tax purposes which are granted to individuals so resident.

(6) In this Article the term "taxation" means taxes of every kind and description.

Article 25
Mutual agreement procedure

(1) Where a resident of a Contracting state considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with this Convention, he may, irrespective of the remedies provides by the domestic law of those States, presdent his case to the competent authority of the Contracting State of which he is a resident.

(2) The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation not in accordance with the Convention.

(3) The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.

(4) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of of the preceding paragraphs.

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U.S.S.R:

The 1984 Budget Act and the Tax System

By Tibor Nagy

Professor Dr. Tibor Nagy was born in Budapest in 1924. He obtained a doctorate in politics at the University of Budapest in 1946 and a doctorate in law a year later. In 1949, he became ministerial secretary in the Supreme Economic Council, and in the year after, deputy chief of the financial department in the Ministry of Education. In 1961, he was awarded the scientific degree "candidate" by the Hungarian Academy of Sciences and, in the same year, was appointed associate professor in the Faculty of Law and Political Sciences at Budapest University, where, in 1969, he became professor and head of the Department of Financial Law. In 1983, Dr. Nagy became a visiting professor at Hamburg University.

Dr. Nagy studied public finance and financial law with research fellowships in the U.S.S.R. (1957), the German Democratic Republic (1959) and Poland (1960). During 1968-1969, he was a Ford Fellow at Harvard and Columbia Universities. He is the author of numerous books and articles on financial law, international financial (tax) law, financial systems and law of the socialist economic integration and the history of Hungarian state finances.

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BRIEF SURVEY OF THE BUDGET LEGISLATION

The last "Appropriation Act" under the Tsarist regime was approved by the parliament (Duma) in 1916. After the 1917 Revolution, budget management was based on six-month estimates (budget plans). The Constitution of the Russian Soviet Federal Socialist Republic of 1918 contains the basic rules on budget law (Articles 79-88), which provide for a State Budget made up of the central and local budgets. Local councils were required to make 6-monthly budget estimates. Their rights in connection with budget planning and management were very precisely defined. The Soviet State Budget system changed in 1920: annual State Budgets were approved by the Supreme Soviets. The concept of the State Budget has had greater importance since 1922, when 4 republics together formed the U.S.S.R.; the U.S.S.R. is now a federation of 15 Union Republics. The State Budget system is based on this constitutional and territorial division.

The Constitutions of 1936 and 1977 did not include detailed budget rules, but there were such rules in the Act of 1959 on the "Budgetary Rights of Union Republics" ("ABR"), as amended in 1969 and 1983.[1] The 15 Republics of the Union have similar Acts, which state the budget rights of the autonomous republics and the other territorial units.[2] The details of budget jurisdiction and process are regulated by these Acts; the annual Budget Acts, i.e. the State Budget Act and the Budget Act of the Union Republics, are concerned only with financial planning. This includes a breakdown of the estimated costs of running the State and the annual revenues (or share) covering these expenses.

These amounts regulate the finances of all the main State ministeries and their subordinate organisations.

THE ANNUAL BUDGET ACTS

On the basis of their Constitutional rights, all the 15 Union Republics have their own annual Budget Acts, but the annual State Budget Act is of greater importance. In accordance with the ABR and similar Acts, the Supreme Soviet regulates the division of fiscal resources between the Union and the Republics and fixes the expenses of the functions and tasks which are the responsibility of the State.

The **State Budget Acts of 1983[3] and 1984[4]** will be dealt with here in detail, because of their political and economic importance. It should be noted that until now this topic has been generally neglected in comparative fiscal studies. By studying the changes in the amounts of revenue and expenditure in the course of several five-year plans, a trend may be seen towards an increase in Union Republics' responsibility and functions and, parallel with this, the Union (federal) State responsibilities and functions. From these figures, the trend in the economic, socio-cultural, defence etc. policies may be analysed on a macro-economic (quantitative and qualitative) scale. To underline this general characteristic, the following are selected statistics of the Union Budgets of some preceding years. These statistics demonstrate that the State Budgets are increasing and that within the frame work of the State Budgets the Budgets of the Union Republics are also growing.

1. *Vedomosti Verchovnogo Soveta* No. 44 of 1959 (Act of 1959), No. 27 of 1969 (amended Act), last modified by Law Decree No. 493 of 1983 No. 32).
2. The U.S.S.R. consists of *15 Union Republics and 20 Autonomous Republics*, i.e. 16 in the RSFSR, 1 in Azerbaijan, 2 in Georgia and 1 in Uzbekistan. (The Budget of an Autonomous Republic consists of its own Budget and the Budget of cities and districts within its territory.) The *territorial units* are: territories, regions, districts, towns, settlements and villages, which also have their own Budget.
3. Budget Act of 1983. *Pravda* No. 329 of 1982 (25 November 1982).
4. Budget Act of 1984. *Pravda* No. 364 of 1983 (30 December 1983).

Table 1
U.S.S.R. State Budget
(millions of rubles)

	1975[5]	1977[5]	1979[5]	1981[6]	1982[6]
Revenue	218,800	247,800	275,600	320,635	353,032
Expenditure	214,850	242,800	275,100	309,793	343,149

The annual Soviet State Budget Acts are all based on the same "model". The European socialist countries have similar Budget Acts: the influence of Soviet legislation may be recognised here.

The Soviet Union has a Federal Budget system which should be analysed both at the Union and the Federal (State) level. This short overview is directed at the Acts at the Union level, in particular, the last two annual Budget Acts. These Acts have an identical legal structure with uniform articles, only the figures vary, in accordance with the changing demands of each state's development.

ARTICLES 1 AND 7 OF THE STATE BUDGET ACTS

As has been the practice for over 40 years, the U.S.S.R. Budget Acts give the amounts of revenue and expenditure of the *State Budget* in Article 1, with a list of all the committees of the Supreme Soviet which proposed the amounts. The annual State Budgets always have a surplus balance (planned deficits are unknown in the Soviet system). Foreign debts – i.e. generally loans to developing countries – are never included in the budget calculation, but domestic debts are included in revenue and their payment is covered in the amount of expenditure.

The Soviet State Budget includes the Union Budget and the Budgets of the 15 Federal Republics. As already indicated, *Article 1* of the State Budget Act sets the totals for the State Budget and within those limits *Article 7* sets the totals for the Union Budget:

Table 2
U.S.S.R. State Budget
(in 1,000 rubles)

	1983	1984
Revenue	354,106,241	366,007,848
Expenditure	353,905,041	365,792,448
Surplus	201,200	215,400

The State Budget is divided between the Union Budget and the Union Republics' Budgets, see Tables 3 and 4.

Table 3
Union Budget
(in 1,000 rubles)

	1983	1984
Revenue	215,618,212	204,071,286
Expenditure	215,417,012	203,855,886

Tables 1-3 present an impressive budget development, in accordance with the rapid growth of the GDP and national income. A trend can also be detected in that the Union Budget is decreasing in favour of the Union Republic Budgets (Table 4), following a policy of decentralization of state agencies and a strengthening of the economic autonomy of the federal states and the local Soviets.

THE BUDGETS OF THE UNION REPUBLICS

Every Union Republic has an independent Budget which encompasses the Budgets of Autonomous Republics and local budgets. The U.S.S.R. Supreme Soviet approves the total sum of revenue and expenditure of every Union Republic. (These two totals are equal, because incomes should cover all expenses, this balancing being a principle in Soviet budgeting.) Comparing Article 8 of the 1983 and 1984 State Budget Acts, it may be stated that the difference between the years and the republics are striking, showing large variations in the territorial economic long-range development programmes. It is these increasing demands that are resulting in the diminishing of the Union Budget (see Table 3).

Table 4
Budget of the Union Republics[7]

Soviet Socialist Republic	1983	1984
	(1,000 rubles)	
Russian Soviet Federative Socialist Republic	74,318,585	88,855,074
Ukrainian S.S.R.	24,102,313	27,786,564
Byelorussian S.S.R.	5,736,689	6,697,359
Uzbek S.S.R.	6,551,300	7,255,894
Kazakh S.S.R.	9,351,120	10,486,744
Georgian S.S.R.	2,387,321	2,781,072
Azerbaijan S.S.R.	2,428,318	2,550,829
Lithuanian S.S.R.	2,703,632	3,237,079
Moldavian S.S.R.	1,952,473	2,264,521
Latvian S.S.R.	1,861,584	2,154,012
Kirghiz S.S.R.	1,647,270	1,788,937
Tajik S.S.R.	1,369,653	1,512,275
Armenian S.S.R.	1,624,872	1,773,021
Turkmen S.S.R.	1,193,437	1,346,033
Estonian S.S.R.	1,259,462	1,447,148
Total	138,448,029	161,036,562

THE REVENUE SIDE OF THE STATE BUDGET

It is characteristic that Article 2 of the State Budget Act deals only with the revenue total from the *socialist sectors,* i.e. from industry, farming, cooperatives, etc.; the principal sources of revenue are listed but without detailed amounts:

5. The Statements' Year Book, 1982-1983, New York, 1982 at 1226.
6. The report of the Council of Ministers of the U.S.S.R. on the execution of the State Budget approved by resolutions of the Supreme Soviet. The totals are cited from these resolutions (1981: Resolution of 24 November 1982. 1982: Resolution of 29 December 1983. Pravda No. 329 of 1982 and 364 of 1983).
7. The list of Republics follows Art. 71 of the Constitution.

Table 5
U.S.S.R. State Budget
(1,000s of rubles)

	1983	1984
Revenues from State and cooperative enterprises and organizations[8] (turnover tax / payment on assets / fixed rent payment / residual profit / deductions from profit / income tax and other revenues from the socialist economy)	324,922,680	335,381,385

The differences in totals of the revenue plans (see Tables 2 and 5) arise from the taxes and fees levied on the population, from income from abroad and from other sources (domestic loans, the taxation of foreign companies etc.). For example, the *taxes paid by population* in the 1984 State Budget amount to only 30,700 million rubles (in 1983: 289,700 million rubles). Consequently, fiscal policy relies basically on income arising from the socialist sector.

(a) **Turnover tax:** Since the 1930 tax reform in the U.S.S.R., turnover tax has had a leading role. This is "incorporated" in the wholesale price of industry (uniform wholesale price and belt wholesale price).[9] The retail price at which goods are sold to the population includes the wholesale price and the trade mark-up (this is to cover the planned expenses of circulation and allows for a profit on the wholesale and retail trading network). The zonal purchasing prices in the socialist agricultural sector also include this tax. The first stage in the process of economic planning is the fixing of prices. The general level of prices is determined by the U.S.S.R. Council of Ministers; in accordance with their decision, the State Committee on Prices sets the wholesale prices of the most important goods produced by industry, agriculture, etc. Other prices are approved by the Councils of Ministers of the Union Republics and by other authorities. The turnover tax rates also depend on the production costs, which are very different in different parts of the country, as well as in the same branch of the economy in the same territory.[10] At present, turnover tax has more than 1,000 rates; there is no uniform tax regulation or uniform tax rates, level or amount. The rates are not published in normal regulations. The taxpayers and the purchasing organizations receive price and tax lists from the authorities. The permanent changes in the rates depend to some extent on variations in the costs of products and services, but primarily, it is geared to prices. The turnover tax is independent from the profit. The tax is levied on all enterprises by virtue of the price regulations. The "elasticity" of the Soviet turnover tax system is one of its characteristic features and remains one of the main subjects of debate on the nature of the tax.

(b) **Payment on assets:** State enterprises which are working under the new conditions (on the basis of the new economic management), i.e. where the "normative method of profit distribution" is applied, are burdened by the payment on assets, the fixed payments and the residual profit (all three being a levy on profits). Other enterprises are obliged to pay only the "deduction from profits".

(c) **Social insurance fee:** This is paid by the socialist organizations and is the second most important tax in the U.S.S.R. The *tax on income from cinematographic performances* is another element of state income documented in Table 5.

(d) **Income tax:** Collective farms pay income tax and the tax on income from cinematographic performances. Other cooperatives are burdened by these two taxes and by the turnover tax and the tax on buildings.

The total revenues from the sources listed above are planned in the State Budget (see Table 5).

THE CONSTITUTIONAL BASIS OF TAX LEGISLATION[11]

In the U.S.S.R., tax legislation is fully centralized. According to the Act on the Budgetary Rights of the Union Republics, Art. 12 (valid from 1983), all payments into the Budget of the U.S.S.R. from state enterprises and organizations, agricultural cooperatives, other cooperatives and social organizations and from the population are contained in the U.S.S.R. legislative Acts and by the Decrees of the Council of Ministers. Taxes paid by the

8. V.F. Garbuzon, Minister of Finance of the U.S.S.R., said in his Budget speech that more than 90% of State income derives from the socialist economic organizations (enterprises and cooperatives). This amounts to 335,200,000 rubles in 1984. About 40% of the profits are retained by the enterprises to finance fixed assets, funds etc. The total of turnover tax was planned at 104,200 million rubles, the income tax of agricultural cooperatives at 800 million rubles in the 1984 Budget (Pravda No. 363 of 1983).

9. The Soviet price system uses the following concepts:

A. *Enterprise wholesale rice:* this is designed to reimburse the enterprise's outlays for production and to provide the enterprise with the necessary profit. This price applies to enterprises when they sell products to each other and to marketing organizations.

B. *Industrial wholesale price:* which may exist "with" or "without" turnover tax. The industrial wholesale price without turnover tax is the enterprise wholesale price plus an amount which is designed to reimburse the supply and marketing organizations for their outlays in purchasing goods from producing enterprises and in the sale and transportation of goods plus an amount to secure the profit planned for such organizations. The industrial wholesale price with turnover tax is the enterprise wholesale price plus the turnover tax plus the amount paid to marketing organizations. For instance, goods are sold for this price outside the industry.

There are two types of industrial whole sale prices:

- uniform ones for the entire territory of the U.S.S.R. (for goods with relatively low transportation costs), and
- belt prices which are differentiated by region (for goods with transportation costs).

C. *Retail prices* are the prices at which goods are sold to the population and include the industrial wholesale price increased by a trade mark-up to cover the expenses of distribution and to create a profit for retail network. There are also uniform and belt prices.

D. *Zonal purchasing prices* are determined for agricultural products supplied by collective farms and State farms to the State. The turnover tax is the difference between wholesale price of agricultural products sold to industry and trade and the State purchasing price, minus expenses and the profit of the procurement organizations.

10. Soviet Finance: Principles, operations. Edited by I.D. Zlobin. Progress Publisher, Moscow 1975, at 121-135.

11. See: M.I. Piskotin: U.S.S.R. (in: *Guides to European Taxation* Vol. V; Taxation in European Socialist Countries, Part. 2).

population are regulated only by U.S.S.R legislative Acts. Union Republics and other, smaller territorial units have no right to introduce taxes, but the Union Republics may introduce fees and levies.[12]

THE NEW SYSTEM OF DISTRIBUTION OF REVENUE

The division of state incomes, taxes, etc. is regulated by the Act of the Budgetary Rights of the Union and the Union Republics. This law is also the *basic legal sources of the "tax sharing system"*, introduced in 1984.

1. **Revenues provided for in the Union Budget (amended Art. 29 of 1983):**
   (a) The turnover tax paid by enterprises and economic organizations, with the exception of that part transferred to the State budgets of the Union Republics.
   (b) The profit payments of state enterprises and economic organizations under Union jurisdiction.
   (c) Income tax paid by Union cooperative and other social organizations and their enterprises and organizations.
   (d) Income tax paid by the population, with the exception of that part of the tax transferred to the State Budget of the Union Republics.
   (e) Income from foreign trade.
   (f) Other revenues, as provided for by U.S.S.R. legislation.
2. **Revenues of the Union Republic Budgets (amended Art. 35 of 1983):**
   (a) Profit payments from enterprises and economic organizations under the jurisdiction of the Republics and local councils.
   (b) Forestry income, income tax from agricultural cooperatives and Republic or local cooperatives and other social organizations and income tax from their enterprises and organizations.
   (c) The agricultural tax.
   (d) 50% of the income tax paid by the population.
   (e) 50% of the revenue from the State lotteries.
   (f) State fees, local taxes and the tax on cinematographic performances.
   (g) Other revenues regulated by U.S.S.R. legislation.
3. The Union Republics are authorized to regulate revenue distribution within their territories, based on the Arts. 29 and 35 of the Act mentioned above.

12. Taxes paid by the population are : (a) income tax; (b) agricultural tax; (c) tax on bachelors and persons with small families. There are many other state duties, local taxes and fees in the U.S.S.R. E.g. *Duties:* inheritance and gift duty, duties on transactions, health resort duty: *Local taxes:* tax on buildings, tax on rental lands, motor vehicle tax; *Fees:* fee on the transfer of immovable property, the charge on collective farm markets, etc. All these were regulated by legislation of the U.S.S.R., but since 1981, fees come under the jurisdiction of Union Republics. See: Hans Janus: Die Kolchosmarktgebühr in der Sowietunion. Zeitschrift WGO-Monatshefte für Osteuropäisches Recht 1981, at 371-373.

DISTRIBUTION OF TAX REVENUE FOR 1983 – 1984

1. On the basis of Art. 29 of the ABR, the Supreme Soviet regulated in the annual Budget Act the proportion of revenue from the turnover tax which was to go to the Union Budget and the Budgets of the Union Republics. The percentages have changed as between the years 1983 and 1984, revealing a trend of an increase in the share in favour of the Union Republics, in line with the way in which their expenses are increasing (see Table 4).

Table 6
Union Republic share of turnover tax revenues

Soviet Socialist Republic	Revenue share (%) *1983*	Revenue share (%) *1984*
Russian Soviet Federative Socialist Republic	41.5	55.9
Ukrainian S.S.R	57.3	65.6
Byelorussian S.S.R.	43.2	49.7
Uzbek S.S.R.	92.3	100
Kazakh S.R.R.	90.0	100
Georgian S.S.R.	48.5	67.4
Azerbaijan S.S.R.	44.9	55.4
Lithuanian S.S.R.	80.6	93.0
Moldavian S.S.R.	49.4	51.3
Latvian S.S.R.	41.8	57.0
Kirghiz S.S.R.	99.0	90.6
Tajik S.S.R.	67.0	71.2
Armenian S.S.R.	42.5	57.5
Turkmen S.S.R.	100	100
Estonian S.S.R.	60.7	74.2

2. The apportionment of the revenues raised from *the income tax paid by the population* is regulated by Arts. 29 and 35 of the ABR of 1983. A 50% share is the minimum limit to be transferred to the Union Republics, but the percentage may be higher, Art. 2 of the ABR; e.g. in the 1983 State Budget Act, a 100% transfer of revenue was effected for Uzbekistan, Kazakhstan and Turkmenistan. In 1984, these three Union Republics and Kirgizia received 100% of the revenue. In 1983 and 1984 all the other Union Republics received the minimum 50% share.
3. In accordance with the 1983 State Budget Act (Art. 9), 50% of the domestic State lottery revenues were transferred to the Budgets of the Union Republics. From 1984, this percentage has been fixed as the minimum share to be transferred to the Budgets of all the Republics.

GRANTS-IN-AID

As has been explained, the Budgets of the Republics and the local budgets are planned on the basis that revenue and expenditure are in balance. In cases where revenue does not cover the planned expenditure, a grant-in-aid may be made from the Union Budget to the Budget of a Union Republic. This occurred in 1984 when Turkmenistan received 27,855,000 rubles to complete its revenue, to finance its economic and social development plans (Art. 9 of the 1984 State Budget Act).

THE TREATMENT OF EXPENDITURE IN THE STATE BUDGET ACTS

The Supreme Soviet approves the total sum of expenditure in the State Budget of the U.S.S.R. The main categories of public expenditure are set out in the annual Budget Acts (Arts. 3-6). The different types of expenditure in the other budget sub-divisions (Republics, etc.) are listed in the Act on Budgetary Rights of the Union and the Union Republics and the corresponding Acts of the Union Republics. The totals are approved by the Supreme Soviet of the Union Republics in the annual Budget Acts, which follow the same system as the State Budget Act.

Table 7 shows the expenditure allowed for in Arts. 3-6 of the State Budget Acts of 1983 and 1984.

Table 7

Category of use	Expenditure (1,000s of rubles) *1983*	*1984*
The State economy (Art. 3) (heavy and light industry, construction, food production and agriculture, transport, housing, public works, etc.)	198,255,961	207,892,995
Social and cultural expenditures (Art. 4)	114,205,560	118,205,427
(including State social insurance)	(43,538,650)	(45,786,345)
National defence (Art. 5)	17,054,000	17,054,000
State administration, courts and public prosecutors' offices (Art. 6)	2,764,085	2,808,332)

The aggregate of the amounts fixed in Arts. 3-6 of the annual Budget Acts does not equal the total of the state expenditures. The difference (1983: 21,625,435 rubles; 1984: 19,831,694 rubles) includes the grants-in-aid to the Union Republics and amounts for financing special domestic and international operations (e.g. foreign aid, government loans, membership fees for intergovernmental organizations and financing common CMEA projects). The difference is borne by both the Union and Union Republic budgets.

Soviet Budget planning is coordinated with the State economic plans. More than 80-85% of national income is distributed and re-distributed via the budget system (funds). The principle of "democratic centralism" dominates in public finance: the rates and amounts of revenue are fixed, the types of state and local functions and tasks for which the revenue is allotted are listed by the Acts and by the legislation of the higher state organs. The execution of the budget is carried out on the basis of centralized planned guidance to independent local organs of State power: the local organs are authorized to determine the specific tasks and the budget limits of spending, but the scheduled outlays are calculated (planned) on the basis of fixed prices, obligatory norms and indicators and the detailed rules of the central and local authorities.

It must be repeated that the most important revenues are the turnover tax and the payment from profits. The increasing expenditure brought about by the trend of expansion and decentralisation of state functions should be covered, in the main, by income from these sources. To guarantee the receipt of these amounts it is necessary to regulate the distribution of profits and, parallel with this, to vary annually the tax sharing rates. This requirement is specifically dealt with in the Budget Acts and by the ABR. The "elastic" regulations on tax and other income are subordinated to these budget laws.

In accordance with the traditional model, the State Budget Act contains 10 articles. So far, Arts. 1-9 have been discussed; the 10th Article contains the constitutional basis of Soviet Budget Law and empowers the Council of Ministers to enforce the Budget:

> **Art. 10**
> The Supreme Soviet authorizes the U.S.S.R. Council of Ministers to survey all propositions and remarks pronounced in the reports on the 1984 U.S.S.R. State Budget of the planning budget and other standing commissions of the Soviet of the Union and the Soviet of Nationalities[13] as well as the propositions and remarks made by the deputies at the Session of the U.S.S.R. Supreme Soviet and to adopt appropriate resolutions.[14]

The executive regulations and decisions of the U.S.S.R. Council of Ministers will be *supervised* by the Supreme Soviet in the following year. The report of the Council of Ministers when accepted will be *adopted* by a resolution of the Supreme Court.

It seems that Soviet budgetary law has become relatively stable. The introduction of a new economic mechanism would not necessarily require changes in this branch of law. Reforms may soon occur in the State revenue regulations, especially the new method of allotment of the enterprise profits and turnover tax rates (in connection with a decrease in costs, arising out of far more effective methods): changes are predicted by economists and politicians. This development is linked with the progress of economic enterprise in conjunction with fiscal jurisprudence. In this way we can understand far better the future trend of Soviet fiscal legislation.

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13. the Supreme Soviet is the highest body of state authority and the primare legislative orgain, it consists of 2 chambers: the Soviet of the Union and the Soviet of Nationalities. See: M.I Piskotin, op cit. page 11.
14. Translated text of Art. 10 of the 1984 State Budget Act (see Note 3).

Tax Havens in the Caribbean Basin

A publication of the Department of the Treasury, January 1984

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CHAPTER I
INTRODUCTION

Section 223 of the Caribbean Basin Economic Recovery Act of 1983[1] ("the Act") requires the Secretary of the Treasury to report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate, not later than 90 days after enactment of the Act, on certain aspects of the use of tax havens in the Caribbean Basin. The Report is to (1) indicate the level of use of Caribbean Basin tax havens to evade or avoid Federal taxes, and the effect on Federal revenues of such use, (2) provide available information on any relationship between such use and other (i.e., non-tax) criminal use, including drug trafficking, and (3) describe current anti-tax haven enforcement activities of the Treasury Department. This Report, prepared jointly by the Treasury Department, the Internal Revenue Service (IRS), and the Justice Department is submitted in response to that requirement.

The request for this Report is indicative of a strong and growing concern shared by the Administration and Congress that tax havens may provide opportunities for the sheltering of both legally and illegally acquired funds and for the avoidance and evasion of U.S taxes. The problems presented by offshore activities in general and tax havens activities in particular are not recent developments. One indication of the continuing concern over these problems can be found in an excellent study prepared by the staff of the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Gov-

1. P.L. 98-67, 5 August 1983.

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ernmental Affairs.[2] This report lists 24 Congressional hearings and reports involving offshore entities, bank secrecy, and related issues.[3] Another excellent report, *Tax Havens and Their Use by United States Taxpayers – An Overview,*[4] prepared by the IRS, provides a thorough discussion of tax havens, their characteristics, and their uses. It also includes many suggestions for reducing the attractiveness of tax havens. This current report is more limited in scope than those two studies; it attempts to update and supplement the sections of those reports which deal with the Caribbean area.

One of the major barriers to dealing effectively with tax haven abuses is the inability of governments to obtain usable information regarding transactions conducted in or through tax havens or tax haven entities. The unilateral grant of U.S. tax benefits under the Act is conditioned on the agreement by beneficiary countries in the Caribbean Basin[5] to exchange information on a reciprocal basis with the United States for the purpose of enforcing the tax laws of each country. The exchange of information provisions of the Act, to the extent countries of the region are willing to enter into such agreements, will be helpful to U.S. authorities in identifying and dealing with tax haven abuses in the Caribbean.

There is no single, clear, objective test which permits the identification of a country as a tax haven. There are, however, a number of factors which are generally accepted as characteristic of tax havens. These include: relatively low rates of tax; bank or commercial secrecy laws or administrative practices which the country is generally unwilling to breach; a banking and financial sector which is large in relation to general levels of domestic economic activity; the availability of modern communications facilities; the absence of currency controls on foreign deposits of foreign currencies; and self promotion as an offshore financial center. The presence of all or a large number of these factors, for purposes of this Report, identifies a country as a tax haven.

There is a wide range of uses of tax havens. Tax haven transactions may be loosely categorized as: (1) transactions that are not tax motivated; (2) transactions that are tax motivated, but consistent with the letter and spirit of the law; (3) transactions that take advantage of unintended legal or administrative loopholes; and (4) transactions designed to escape legal obligations through fraudulent means.

Chapter II of the report provides more detail on the characteristics and uses of tax havens. Chapter III presents the available statistics on the use of Caribbean tax havens. The data support the perception that the use of Caribbean tax havens is expanding. Chapter IV describes the anti-tax haven activities undertaken by the Treasury Department, the IRS, and the Justice Department to combat the use of tax havens in the Caribbean to evade or avoid U.S. Federal taxes or to engage in criminal activities, such as narcotics smuggling. Chapter V summarizes the conclusions reached.

CHAPTER II
TAX HAVENS – IN GENERAL

A. Overview

International tax avoidance and evasion, including the use of tax havens to avoid or evade U.S. taxes, have been of long-standing concern to Congress and the IRS. Numerous provisions have been added to the U.S. tax laws to limit such use, and to limit the erosion of the U.S. tax base. Nevertheless, legal and illegal use of tax havens appears to be on the increase.

The focus of this report is tax haven activity in the Caribbean Basin. Identifying countries which are part of the Caribbean Basin is relatively easy. Section 212(a)(1)(A) of the Act lists 27 countries and section 222(a) of the Act adds Bermuda to the list for purposes of the tax provisions of the Act. Unfortunately, there is no single, clear, objective test which permits the identification of a country as a tax haven.

The Gordon report identified a number of factors which are generally accepted as characteristic of tax havens.[6] These include: relatively low rates of tax; high levels of bank or commercial secrecy which the country is generally unwilling to breach; a disproportionately large financial sector; modern communications facilities; the absence of currency controls on foreign deposits of

2. U.S. Senate Committee on Governmental Affairs, Permanent Sub-committee on Investigations, *Crime and Secrecy: The Use of Offshore Banks and Companies,* 1983, hereafter cited as the Senate report.
3. Ibid., pages 128-131.
4. Internal Revenue Service, *Tax Havens and Their Use by United States Taxpayers – An Overview,* January 1981. This report was prepared for IRS by Richard A. Gordon and is cited hereafter as the Gordon report.
5. Bermuda is considered to be part of the Caribbean Basin for purposes of the tax provisions of the Act. See Section 222(a) of the Act.
6. Much of the material in this Chapter is drawn from the Gordon report.

foreign currencies; and self promotion as an offshore financial center. These characteristics are described below.

Although many of the Caribbean Basin countries exhibit one or more of these characteristics, five countries (the Bahamas, Bermuda, the Cayman Islands, the Netherlands Antilles, and Panama) account for most of the international financial activity of the region and are the focus of this report. The financial data in this report are limited to these five countries. The data presented in this report are generally limited to the period 1978 through 1982.[7]

B. Characteristics of tax havens

Many countries have a low or zero rate of tax on all or certain categories of income and offer a certain level of banking or commercial secrecy. In most countries, including most tax havens, these characteristics generally have some legitimate reason for existence. However, tax havens typically have extended or strengthened their bank secrecy laws and have taken other steps to improve their competitive positions as tax havens. The following discussion describes the principal characteristics of tax havens. None of the statements in this section should be interpreted as implying either that all tax havens or all Caribbean tax havens have any particular characteristics.

1. Low tax rates

Many of the jurisdictions that are considered tax havens do impose some taxes. All tax havens, however, impose no income tax either on all or on certain categories of income, or impose a tax whose effective rate is low when compared to the tax imposed by the countries whose resident taxpayers use the tax haven.

In the Caribbean, the Bahamas, Bermuda, the Cayman Islands, and the Turks and Caicos do not impose any income or wealth taxes. In those particular cases, the absence of an income tax is part of a policy to attract foreign banking, trust, or corporation business. There may also be cases where the country has not found it necessary or administratively feasible to impose an income tax. Many Caribbean countries are small, less-developed countries whose residents are generally poor. The small proportion of the population with income above the subsistence level may make an income tax system impractical. The country may be able to collect more revenue at a lower cost through customs duties, licenses, and fees.

Some tax havens impose low rates of tax on income from specific types of business. The Netherlands Antilles, for example, offers special tax rates to holding companies. By combining its tax system with its U.S. treaty, the Antilles has made itself an especially desirable situs for forming a holding company. Panama offers special tax benefits to shipping income, and Barbados favors international financial companies.

2. Bank and commercial secrecy

The jurisdictions with which this report is concerned generally afford restrictive rules of secrecy or confidentiality to persons transacting business in or through those jurisdictions. These secrecy rules are based either on statutes, common law precedent, or administrative practice.[8] Many Caribbean Basin jurisdictions were or are British Colonies and follow common law precedent which accords a privileged relationship to information which a banker receives from his customer. This has evolved into a standard basis for affording the protections of secrecy to banking affairs in these jurisdictions.

Some jurisdictions have enacted secrecy or confidentiality statutes. For instance, in the Bahamas, the Bank and Trust Company Regulatory Act prohibits disclosure of bank information by persons acting on behalf of a bank, including officers, employees, attorneys or auditors, and provides for penal sanctions in the event the Act is violated. The Cayman Islands has also enacted statutes which provide for substantial sanctions against persons divulging most types of banking and commercial information other than under a procedure supervised by a Cayman Islands court. The Cayman Islands increased the sanctions for violating this law following the case of *United States* v. *Field*,[9] in which a U.S. court directed a Cayman resident to give testimony concerning bank information before a U.S. grand jury, even though the testimony caused the person to violate the bank secrecy laws of the Cayman Islands and subjected the individual to limited criminal penalties.[10]

The secrecy rules of Caribbean tax havens are troublesome when a violation of U.S. criminal laws is under investigation, but they also present significant problems to the IRS when it attempts to audit legal transactions. If a taxpayer is reluctant to provide necessary information to the IRS, the secrecy can be used to prevent the IRS from obtaining access to records from the foreign jurisdiction.

3. Relative importance of banking

Banking tends to be more important to the economy of a tax haven than it is to the economy of a non-tax haven. Most tax havens follow a policy of encouraging offshore banking business. This is done by distinguishing between resident and non-resident banking activity. Generally, non-resident activity will not have reserve requirements, will be taxed differently (if at all), and will not be subject to foreign exchange or other controls. It also enjoys the guarantees of secrecy discussed above.

Tax havens thrive in large part because of the presence of foreign banks. Financial activity generates revenue in

7. For information relating to other tax havens and to years before 1978, see the Gordon report.
8. The Senate report contains brief "country sketches" for several Caribbean Basin countries (Antigua, the Bahamas, Bermuda, Montserrat, Panama, and the Cayman Islands). These country sketches outline the operation of the secrecy rules and place them in a social and political context. Appendix I of the Senate report contains a variety of documents relating to the banking, commercial secrecy, and disclosure laws of about 20 countries.
9. *United States* v. *Field*, 532 F.2d 404 (5th Cir. 1976); *cert. denied*, 429 U.S. 940 (1976).
10. In the case of the *United States of America* v.*Carver, Le Mire et al.*, a Cayman Islands court honored a U.S. request for judicial assistance to obtain bank information in a U.S. criminal proceeding. The Cayman Islands Court of Appeals (which is the Court of Appeal for Jamaica exercising jurisdiction in accordance with the Cayman Islands Constitution), ordered the bank employees named in the U.S. request to testify in the United States and provide supporting bank records.

the form of fees and modest taxes on financial institutions. The tax haven also benefits to some extent from the employment of local personnel and the rental of local facilities. The financial activities create an infra-structure which can be utilized both by criminals and by legitimate businesses.

One test of the importance of banking to an economy is the relationship of foreign assets of banks in a country to that country's foreign trade. When compared to foreign trade, foreign assets of deposit banks in tax haven jurisdictions that are offshore banking centers are typically much greater than foreign assets of deposit banks in non-tax havens. Chapter III contains data on banking as well as investment and income flows between the United States and Caribbean Basin countries.

After World War II, Eurocurrency lending (lending by a bank in a currency other than that of its country of residence) grew rapidly. Throughout the 1950s a European market for U.S. dollars outside of the United States developed. The uncertain world situation, the increased awareness of corporate treasurers of the advantages of depositing dollars abroad (higher interest), and other factors contributed to the growth of this market, which was further aided by the various U.S. measures introduced in the 1960s to reduce capital outflows. Such measures included the Interest Equalization Tax (IET) of 1963, the voluntary Foreign Credit Restraint Program of 1965, and the Office of Foreign Direct Investment regulations, which required U.S. persons investing abroad to borrow abroad. These measures had the effect of segmenting the market (i.e., encouraging domestic borrowing for domestic purposes and foreign borrowing for foreign purposes). In 1969, the Federal Reserve Board agreed to permit the establishment of shell branches abroad so that smaller banks could enjoy the same advantages as larger banks in competing in the international financial market.

Most large banks, U.S. and foreign, have branch offices in the Bahamas and the Cayman Islands. They are there primarily to participate in the Eurodollar market, taking dollar deposits from foreign persons and lending them to their foreign or U.S. customers. Prior to December 1981, if such transactions were effected from the United States, the deposits would have been subject to reserve requirements imposed by the Federal Reserve. (Under those requirements, a portion of any deposit must be held and cannot be lent out; thus, that reserved portion cannot produce income.) Interest rate ceilings and insurance requirements also applied. Since December 1981, the Federal Reserve Board has permitted U.S. banks and U.S. offices of foreign banks to establish International Banking Facilities which enable them to deal with foreign customers free of reserve requirements, interest rate ceilings, and insurance requirements without resort to an offshore lending facility. Consequently, the use of Caribbean branches has become relatively less attractive to U.S. banks.

4. Availability of modern communications

Many of the countries considered to be tax havens have excellent communications facilities, particularly telephone, cable, and telex service linking them to other countries. They may also have excellent air service. For example, the Cayman Islands has well-developed telephone and telex facilities; telephone numbers in the Caymans can be dialed directly from the United States and Canada. There are two daily non-stop jet flights between Miami and the Caymans, and direct service between Houston and Grand Cayman. The use of English as the principal language in many Caribbean jurisdictions and the convenience of being in approximately the same time zones as U.S. financial centers contribute to making them especially attractive to U.S. (and Canadian) residents.

5. Lack of currency controls

Many tax havens have a dual currency control system, which distinguishes between residents and non-residents, and between local currency and foreign currency. As a general rule, residents are subject to the currency controls; non-residents are not. However, non-residents will normally be subject to controls with respect to local currency. These rules are adapted to facilitate the use of the tax haven by a person wishing to establish a tax haven entity to do business in other jurisdictions.

A company formed in a tax haven, which is beneficially owned by non-residents and which conducts most of its business outside the tax haven, is generally treated as non-resident for exchange control purposes. Accordingly, a foreign person can form a tax haven company to do business in other jurisdictions. The company's operations will not be subject to the tax haven's exchange controls as long as it is dealing in the currency of other jurisdictions and is not doing business in the tax haven.

6. Self promotion

Most tax haven countries seek financial business and promote themselves as tax havens. Some jurisdictions conduct seminars, and their officials collaborate in articles extolling the virtues of the particular country as a haven. Tax havens facilitate organization, maintenance, and operation of tax haven entities by providing access to competent professional advisors (accountants and lawyers) and by adopting flexible, easily utilized, commercial laws.

7. Tax treaties

Though some tax havens, such as Switzerland, maintain an extensive network of tax treaties, most tax havens do not enter into tax treaties. Some tax havens, however, have entered into treaties which, because of the combination of treaty benefits granted by the treaty partners and favorable internal law provisions in the tax haven, make these jurisdictions particularly attractive for certain kinds of transactions. For example, the Netherlands Antilles has an income tax treaty with the United States which provides an exemption from U.S. tax on certain interest paid by U.S. persons to Netherlands Antilles residents.

C. Uses of tax havens

Tax havens may be used for a variety of purposes. While some tax haven uses may be for criminal purposes, many of the uses are legal. In some cases, the tax consequences of the tax haven transactions reflect Congressional decisions as to the appropriate limits of U.S. taxing jurisdiction, such as deferral of U.S. tax on the unrepatriated earnings of a foreign subsidiary controlled by a U.S. resident.

Often whether a transaction is tax avoidance or tax evasion is difficult to determine, in part because the terms are not well defined, and in part because the law governing the transactions is imprecise and the information incomplete. Tax haven transactions can be loosely categorized as follows:

(1) Transactions that are not tax motivated and may have little or no U.S. income tax impact. Such use includes branch banking that may avoid U.S. reserve requirements, but may have little impact on U.S. income tax liability. A tax haven subsidiary may be used to avoid or minimize the effect of currency and other controls that may be imposed by countries in which the company is (or related companies are) carrying on business. It may also be used to minimize the risk of expropriation of business assets. A foreign person may use a tax haven bank or nominee account to shield knowledge of the existence of assets from governments that may misuse such information or from terrorist groups.

(2) Transactions that are tax motivated but consistent with the letter of the law ("tax planning"). Examples include the use of "flags of convenience" by the shipping industry, banking through subsidiaries, sales through tax haven subsidiaries to unrelated parties, and structuring tax haven operations to take advantage of certain de minimis exceptions to anti-tax haven legislation.

One of the most common tax-motivated but legal uses of a tax haven subsidiary is to convert U.S. source income to foreign source income in order to increase the limitation on the amount of foreign income taxes paid by a U.S. taxpayer that can be credited against, and thus reduce, U.S. taxes otherwise payable by the taxpayer.

(3) Transactions that take advantage of an unintended legal or administrative loophole ("tax avoidance"). Examples include the use of captive insurance companies, the use of certain investment or factoring companies, some forms of service and construction businesses being conducted through tax haven entities, as well as a wide range of aggressive transfer pricing situations. Typically, the purpose of such transactions is to shift profits to controlled entities in tax free areas. One loophole that recently has been noted by commentators is to use an offshore factoring corporation to buy trade receivables from a related U.S. company. In certain circumstances the discount income earned by the factor will not be subpart F income and will not be subject to direct U.S. tax. Interest income earned on a loan secured by the receivables would be subpart F income.

(4) Transactions designed to escape taxation through fraudulent means ("tax evasion"). This category includes so-called "double trust" schemes designed to allow the transfer of U.S. assets to tax haven trusts without incurring any U.S. tax liability and to hide the income from such assets. It also includes the utilization of sales companies that are structured to appear to reflect dealings only with unrelated parties but which in fact are dealing with related parties, forming corporations to appear to be banks, hiding the fact of beneficial ownership of tax haven corporations, and the use, by U.S. persons, of tax haven entities to hide corporate receipts and corporate slush funds.

Tax havens may be used to commit crimes that violate non-tax as well as tax laws. The most serious fraudulent use of this kind is by narcotics traffickers to accumulate or launder large sums of cash. Often phony shelter schemes violate securities as well as tax laws. These schemes may be conducted through a tax haven in order to hide the fact that the transactions that are allegedly creating losses have not actually taken place. Shell banks established in tax havens have been used to defraud U.S. banks and other businesses. Specific examples of fraudulent use of tax havens based on recent cases are presented in Chapter IV.

D. Institutional background

For U.S. taxpayers, tax havens, in and of themselves, do not generally provide a U.S. tax advantage because the United States taxes world-wide income. The U.S. tax advantage is generally provided only in combination with the U.S. system of deferral of taxation of unremitted earnings of foreign corporations, the U.S. system of foreign tax credits, and the provisions of an applicable tax treaty. Non-residents may seek to reduce their U.S. tax liability directly by manipulating transfer prices to shift U.S. profits to a tax haven subsidiary. They may also try to escape U.S. tax by "treaty shopping", i.e. routing transactions with the United States through a country other than their country of residence with which the United States has a tax treaty which reduces U.S. tax, such as the withholding tax on dividends, interest, and royalties.

There are provisions in the Internal Revenue Code designed to prevent tax avoidance through the use of tax havens, but they are among the most complex in the Code. The two most important provisions affecting tax haven transactions are subpart F, which taxes United States shareholders of a U.S.-controlled foreign corporation (CFC) on certain categories of income earned by the CFC, and Section 482, which authorizes the Commissioner to reallocate income among related entities (including U.S. and foreign entities) to properly reflect their income. Both of these provisions are primarily transactional in nature, that is, each separate transaction must be analyzed to determine its tax effect. In addition, the foreign personal holding company, foreign investment company, and foreign trust provisions may apply.

The proper administration of subpart F and Section 482 often requires IRS access to detailed books and records which may be located outside the United States and therefore are not always available. The complexity of the law, coupled with information-gathering problems, makes this area of the tax law extremely difficult to administer. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) included several provisions designed to improve taxpayer compliance.[11]

11. See Chapter IV for a discussion of these provisions.

As stated above, income tax treaties with tax havens are often used by residents of nontreaty countries to achieve a reduction in U.S. tax. Residents of treaty countries may also use tax haven treaties where the U.S. tax benefits under these treaties are greater than the benefits under the U.S. treaty with their country of residence. Third-country residents use such treaties primarily to minimize tax on income from U.S. investments by a combination of reduced rates of tax on income paid from the United States, the low rate of tax in the tax haven, and the low rate of tax on distributions to the investor from the tax haven. The use of tax haven treaties includes establishing holding companies to engage in back-to-back licensing and dividend repatriation transactions, real estate investments, and finance companies established by U.S. corporations to borrow abroad free of withholding tax.

There is some concern that tax haven treaties may be used to evade U.S. tax. The Treasury Department is addressing this issue through its tax treaty policy.[12] Many of the U.S. income tax treaties with tax havens resulted from the extension of the old United States–United Kingdom treaty to former United Kingdom colonies. The treaty with the British Virgin Islands was terminated by the United States, effective 1 January 1983, and the other such treaties have been terminated by the United States effective 1 January 1983.[13] The treaty with the Netherlands Antilles is in force as a result of the extension of the United States–Netherlands income tax treaty. That treaty is currently being renegotiated.

TABLE I
Foreign assets of deposit banks
1978-1982
($ billions)

	1978	1980	1982
A. Ratio of foreign assets to merchandise exports			
World	0.87	0.85	1.34
Industrial countries	0.90	0.99	1.45
Oil-producing developing countries	0.10	0.10	0.22
Non-oil developing countries	1.27	1.00	1.73
Selected Caribbean countries			
Bahamas	46.20	24.47	36.42[e]
Bermuda	32.75	57.00	108.33[e]
Cayman Islands	1	1	1
Netherlands Antilles	1.06	1.90	3.90[e]
Panama	61.96	91.64	114.30
United States	0.74	0.79	1.72
B. Foreign assets above or below the average level ($ billions)			
Selected Caribbean countries in relation to average for all non-oil developing countries			
Bahamas	94.8	11.4	134.6[e]
Bermuda	1.3	2.2	3.2[e]
Cayman Islands	49.0	84.5	127.7
Netherlands Antilles	–0.6	3.0	6.0[e]
Panama	16.4	32.6	41.4
Total five countries	160.9	123.7	312.9
United States in relation to average for all industrial countries	–22.8	–24.7	56.8

Office of the Secretary of the Treasury
Office of Tax Analysis
e. Estimate.
1. Since merchandise exports are negligible, the ratio approaches infinity.

Source: Bureau of Statistics of the International Monetary Fund, supplemented by joint IMF-IRS staff estimates, and Central Statistical Office, Cayman Islands, *1982 Statistical Abstract*, August 1983, and Annual Reports of the Cayman Islands Currency Board.

CHAPTER III
DATA ON LEVELS OF USE OF CARIBBEAN TAX HAVENS

A. Banking

As mentioned in Chapter II, one of the common characteristics of tax havens is the great importance of the banking sector relative to the country's economy and, in particular, to the country's need for foreign assets to finance its foreign trade. Large economies and those in which foreign trade accounts for a substantial portion of the gross national product would be expected to maintain larger holdings of foreign assets than small economies and those in which foreign trade is limited.

One simple measure of the concentration of foreign financial assets is the ratio of foreign asset holdings to foreign trade. A comparison of that ratio for any given country with the world-wide ratio gives an indication of the extent to which the country may be holding "excess" foreign assets in relation to the amount needed to finance its foreign trade. Like any average, the world-wide ratio does not necessarily represent the world-wide norm; it gives equal weight to deviations above and below the norm. Nevertheless, it is useful as a rough standard, keeping in mind that a ratio in excess of the average may in some cases be explained by other factors than tax haven status.

Table 1 shows the ratio of foreign asset holdings of banks to merchandise exports for selected countries, including the five Caribbean jurisdictions which are the focus of this report. The average is shown separately for all industrial countries, developing countries which are major oil producers, and developing countries which are not major oil producers.

A decline in exports associated with slow economic conditions contributed to a general increase in the average ratios in 1982. But, four of the five Caribbean jurisdictions have consistently held foreign assets well in excess of the average for non-oil developing countries. The exception is the Netherlands Antilles, where the ratio has increased much faster over the period 1978-1982 than the average, but remains well below the ratios of the other four Caribbean countries. While developing countries (other than oil producers) maintained foreign assets equal to 1.73 times their merchandise exports in 1982, foreign assets of banks in Bermuda, the Cayman Islands, and Panama were sufficient to finance more than 100 times those countries' exports, respectively, and in the Bahamas the ratio was over 36. Converting those ratios

12. See Chapter IV for a discussion of U.S. tax treaty policy.
13. The countries in the Caribbean Basin whose treaties have been terminated are: Anguilla, Barbados, Belize, Dominica, Grenada, Montserrat, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines. Antigua and Barbuda terminated its treaty with the United States effective 26 August 1983.

into dollar figures implies that the principal depositories of such funds among the five Caribbean jurisdictions were the Bahamas, the Cayman Islands, and Panama, which together accounted for over $300 billion of "excess" holdings of foreign assets in 1982.

Table I also shows that, while the U.S. ratio of foreign assets to exports was below the average for all industrial countries in 1978 and 1980, it significantly exceeded the average in 1982, with over $55 billion in "excess" holdings in that year compared to a shortfall of nearly $25 billion in 1980. The sharp change in 1982 is attributed largely to the establishment of international banking facilities (IBFs) in the United States. Beginning in December 1981, the Federal Reserve Board permitted U.S. banking offices – including U.S.-chartered banks, agencies and branches of foreign banks, and offices of Edge Act corporations – to accept deposits from and make loans to foreign residents free of reserve requirements and interest rate ceilings. IBFs are also excused from the insurance requirements of the Federal Deposit Insurance Corporation. Several states also offer tax exemptions. There is no special Federal income tax exemption for IBFs, but they enjoy the same rules available to other U.S. banks. In addition, non-resident depositors in IBFs are generally exempt from U.S. tax on the interest on such deposits. (Interest on bank deposits of foreign residents which is not effectively connected with a U.S. trade or business is not considered U.S. source income.) Thus, IBFs, without using an offshore facility, can provide international banking services to foreign customers on roughly the same regulatory and tax basis as the Eurocurrency market.

By early September 1982, nearly 400 banking institutions had established IBFs with assets of over $150 billion and liabilities of about $135 billion.[14] Part of the assets and liabilities were shifted from the books of existing entities, including shifts from branches of U.S. banks in the Bahamas and Cayman Islands. Claims on and liabilities to unrelated foreign residents at Caribbean branches of U.S. banks that established IBFs declined by amounts roughly similar to the estimated shifts to IBFs from foreign offices of U.S. banks in December 1981 and January 1982.[15] As a consequence, the increase indicated in Table 1 in foreign assets of U.S. banks may represent in part funds which would otherwise have appeared as further increases in the holdings of banks in the Caribbean.

Additional information on international banking transactions through the Caribbean is shown in Table 2. The figures in Table 2 relate to international transactions only; they exclude transactions of local residents with local banks. This has the advantage of excluding purely local transactions, such as those with local hotels and restaurants, which do not involve tax evasion or other illegal activities. However, it has the disadvantage of also excluding any activities which are routed through a Caribbean entity, such as a trust, but which involve foreign deposits or borrowing. It should be noted that the banks covered include not only locally-chartered banks but also branches of United States and other foreign banks. Country detail for the Caribbean countries is shown in Table 3 and some detail on the branches of U.S. banks is shown in Table 4. All of the data in Tables 2 through 4 are estimates of mid-year balances. They do not reflect the volume of debits and credits during the year.

In Table 2, the claims of Caribbean banks represent the credits extended to non-residents and securities acquired from non-residents. The banks' liabilities consist primarily of the deposits of non-residents. They may also cover other forms of bank indebtedness, such as bankers' acceptances. They do not include the capital accounts, consisting of shares, reserves, and undistributed profits. Funds evading tax or from other illegal activities would rarely show up in the capital accounts; they typically appear as deposits.

More than two-thirds of the transactions shown in Table 2 took place between banks. In 1982, banks in the five Caribbean countries held $210 billion of deposits of non-resident banks and had outstanding credits of $202 billion to non-resident banks. However, transactions involving non-bank entities were rapidly increasing. In 1982 the Caribbean banks held $105 billion of deposits of non-residents other than banks (trusts, nominees, investment companies, individuals) and had outstanding credits to such persons of $116 billion. At the same time, similar entities or individuals based in the Caribbean had deposits of (claims on) non-resident banks totalling $24 billion and outstanding credits from (liabilities to) such banks of nearly $18 billion. As mentioned earlier, data are not available on the extent to which Caribbean trusts or similar local entities may be used by non-residents to make deposits in or to borrow from Caribbean banks.

TABLE 2
International banking in Caribbean offshore financial centers 1978-1982
($ billions)

	1978	1980	1982
Caribbean banks (including branches of foreign banks)			
Claims on non-residents	178.4	254.1	318.2
banks	115.2	162.7	201.9
others	63.1	91.4	116.3
Liabilities to non-residents	178.3	253.2	314.7
banks	135.8	181.0	210.1
others	42.5	72.2	104.6
Other Caribbean entities and individuals			
Claims on non-resident banks	9.4	16.4	23.6
Liabilities to non-resident banks	1.9	10.2	17.5

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Source: Estimates by the Bureau of Statistics of the International Monetary Fund and data from the Central Statistical Office, Cayman Islands, *1982 Statistical Abstract*, and Annual Reports of the Cayman Islands Currency Board. These estimates are not consistent with the earlier series for 1968, 1973 and 1978 published in the Gordon report, which were prepared for IRS by a consultant based on a different methodology.

14. See: Key, Sidney J., "International Banking Facilities", *Federal Reserve Bulletin*, October 1982.
15. Ibid.

Table 3 disaggregates the data of Table 2 by country for the latest year, 1982. It shows that over 80% of the international transactions of banks of the five countries are accounted for by banks in the Bahamas and the Cayman Islands, each of which accounts for roughly 40% of the total. Panama ranks third, while the level of activity in the Netherlands Antilles and Bermuda is low. Transactions of local banks with non-residents other than banks, e.g. trusts, is most important in the Cayman Islands. In the case of Panama, banks were the principal non-resident depositors while nonbanks were the principal non-resident debtors of Panamanian banks. Panama also accounted for a large share of the activity of local entities other than banks with respect to both deposits in and borrowing from non-resident banks.

TABLE 3
International banking in Caribbean offshore financial centers Country detail, 1982
($ billions)

	1982 Total	*Bahamas*	*Bermuda*
Caribbean banks (including branches)			
Claims on non-residents	318.2	132.3	3.7[e]
banks	201.9	111.8	3.7[e]
others	116.3	20.5	—
Liabilities to non-residents	314.7	132.5	8.5[e]
banks	210.1	90.6	0.8[e]
others	104.6	41.9	7.7[e]
Other Caribbean entities and individuals			
Claims on non-resident banks	23.6	2.4	6.1
Liabilities to non-resident banks	17.5	1.3	2.0

	Cayman Islands	*Netherl. Antilles*	*Panama*
Caribbean banks (including branches)			
Claims on non-residents	127.7	11.0	43.5
banks	72.3	3.4	10.7
others	55.4	7.6	32.8
Liabilities to non-residents	150.1	10.7	42.9
banks	76.2	8.4	34.1
others	43.9	2.3	8.8
Other Caribbean entities and individuals			
Claims on non-resident banks	2.1	3.4	9.6
Liabilities to non-resident banks	3.0	3.1	8.1

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e. Estimate.

Source: Estimates by the Bureau of Statistics of the International Monetary Fund and based on data from the Central Statistical Office, Cayman Islands, *1982 Statistical Abstract,* and Annual Reports of the Cayman Islands Currency Board.

Table 4 contains data on the assets and liabilities of all foreign branches of U.S. banks and of those foreign branches located in the Bahamas, the Cayman Islands, and Panama during the period 1978 through 1982. The branches in the Bahamas, the Cayman Islands, and Panama account for approximately one-third of the total deposits in all foreign branches of U.S. banks. (There are also branches in the Netherlands Antilles which accounted for about $1-2 billion in deposits in 1979 and 1980; the information for 1982 is not disclosed, to protect the confidentiality of the banks involved.) Deposits of persons other than banks (e.g., trusts, investment companies, individuals) increased more rapidly than deposits of banks for all foreign branches, but especially for the Caribbean branches. Money on which tax is being evaded or which arose from illegal activities may be concealed in such deposits. Nonbank deposits in the Caribbean branches were nearly 2.5 times the 1978 level in 1982, while those in other foreign branches (obtained by subtracting the Caribbean figure from the total foreign figure) were 1.6 times the 1978 level in 1982.

TABLE 4
Selected accounts of Caribbean and all foreign branches of U.S.-chartered banks 1978-1982
($ billions)

	1978	*1980*	*1982*
Branches of U.S. banks in the Bahamas, Cayman Islands, and Panama			
ASSETS	96.8	128.6	151.2
claims on banks	59.3	89.2	124.9
claims on others[1]	37.5	39.4	26.3
LIABILITIES	97.3	128.0	152.3
to banks[1]	76.8	92.7	102.1
to others	20.5	35.3	51.0
with U.S. addresses	13.0	24.6	39.9
with other addresses	7.5	10.7	11.1
All foreign branches of U.S. banks			
ASSETS	214.5	383.4	450.0
claims on banks	109.8	251.9	316.5
claims on others[1]	104.7	131.5	133.5
LIABILITIES	296.8	386.4	449.8
to banks[1]	237.8	294.1	315.4
to others	59.0	92.3	114.4
with U.S. addresses	17.2	37.3	70.2
with other addresses	41.8	55.0	64.2

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1. Claims on others include claims on official institutions as most official borrowing is attributed to foreign governments or government enterprises. In contrast, liabilities to official institutions are counted as liabilities to banks because most official deposits are attributed to central banks.

Source: Unpublished tables from the Board of Governors of the Federal Reserve System.

The figures on Caribbean branches in Table 4 differ from those in Table 2. The former include any transactions with local residents but exclude branches in Bermuda and the Netherlands Antilles and any banks organized as subsidiary in the five countries. Nevertheless, a very rough estimate of the nonbank deposits in Caribbean banks other than branches of U.S. banks can be made by comparing the magnitude of such deposits in the two tables. That comparison suggests that U.S. branches accounted for about one-half of the nonbank deposits in Caribbean banks throughout the period 1978-1982 (e.g., $51 billion of the $104.6 billion in 1982). As noted earlier, the activity of U.S. bank branches in the Caribbean would probably have been higher in 1982 but for the shifting of some transactions to IBFs in the United States.

B. Investment and income flows

1. U.S. direct investments in the Caribbean

The Department of Commerce collects and tabulates data on U.S. direct investments in foreign countries. Direct foreign investment is defined as an investment in which a U.S. person owns or controls, directly or indirectly, 10% or more of the voting stock of an incorporated foreign business enterprise, or a comparable interest in an unincorporated foreign business enterprise, such as a branch. Table 5 summarizes U.S. direct investment in Caribbean tax havens, other than the Netherlands Antilles, during the period 1978-1982. The corresponding data for the Netherlands Antilles are shown separately in Table 6. Table 7 provides data on the reverse flow of direct investment into the United States from selected Caribbean countries during the same period.

As Table 5 illustrates, the level of U.S. direct investment in the Caribbean tax havens other than the Antilles increased substantially from 1978-1982, rising from about $14 billion to about $20 billion. The rate of increase was the same as that of U.S. direct investment abroad from 1978 to 1982, slightly lower from 1978 to 1980 and slightly higher from 1980 to 1982. The Netherlands Antilles is excluded from these comparisons because the volume of borrowing by U.S. corporations from Netherlands Antilles affiliates has become so large that it distorts the picture of other foreign investment activity. (Total U.S. foreign investment abroad declined in 1981, for the first time since World War II, as a result of the negative outflow to the Netherlands Antilles.)

The composition of Caribbean investments is concentrated in the financial and trade sectors, which tend to be highly mobile, more than is the case for world-wide U.S. direct foreign investments. Of world-wide foreign direct investment in 1982, 41% was in manufacturing compared to 25% in trade and finance. For the Bahamas, Bermuda, and Panama only 2% was in manufacturing and over 85% in trade and finance.[16]

The direct investment picture in the Netherlands Antilles is dominated by the activities of finance subsidiaries of U.S. corporations which borrow abroad, primarily in the Eurobond market, to relend to their U.S. parent corporations. Under the income tax treaty between the United States and the Netherlands Antilles, interest payments on such borrowing by the U.S. corporations is free of U.S. tax. A small tax is paid to the Antilles on the spread between the rates at which the finance subsidiary borrowed and loaned, and the interest is paid out to the Eurodollar lender without any withholding tax in the Antilles. (The tax paid to the Netherlands Antilles may be claimed as a foreign tax credit against any U.S. tax due by the parent corporation under subpart F.)

As shown in Table 6, the volume of net borrowing from Netherlands Antilles finance affiliates increased more than ten times, from $2.5 billion to $27.3 billion, in only four years. The volume of such borrowing nearly doubled from 1981 to 1982, reflecting not only the lower in-

16. Source: U.S. Department of Commerce, *Survey of Current Business*, August 1983.

TABLE 5
U.S. direct investment in Caribbean tax havens other than the Netherlands Antilles[1]
1978-1982
($ millions)

	1978	1980	1982
Level of U.S. direct investment	13,523	17,906	19,701
Outflow of U.S. equity and debt capital (including trade credit)	1,414	705	687
Earnings of Caribbean affiliates[2]	2,224	3,297	3,410[e]
Reinvested earnings of subsidiaries	624	1,240	1,334[e]
Subsidiary dividends & branch profits	1,600[e]	2,057	2,076[e]
Inflow to U.S. owners of dividends, branch profits & interest[3]	1,674	2,060	2,063[e]
Level of U.S. direct investment, all other countries (except Netherlands Antilles)	150,034	201,805	217,235
Investment in Caribbean as a percent of other foreign investment	9.0%	8.9%	9.1%

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e. Estimate.
1. Also includes some small islands not covered in other tables.
2. Net of any foreign corporate tax.
3. Net of any foreign withholding tax.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* August issues. Washington, D.C., U.S. Government Printing Office, and unpublished tabulations.

TABLE 6
U.S. direct investment in the Netherlands Antilles
1978-1982
($ millions)

	1978	1980	1981	1982
A. All Netherlands Antilles affiliates				
Level of U.S. direct investment	–830	–4,336	–7,172	–15,593
Outflow of U.S. equity and debt capital (including trade credit)	–68	–2,843	–3,449	–9,606
Reinvested earnings of subsidiaries	35	206	587	886
Inflow to U.S. owners of dividends branch profits & interest	–41	–173	–986	–2,593
B. Finance affiliates only				
Level of U.S. direct investment	–1,389	–4,802	–7,761	–16,172
Loans from N.A. affiliates	–2,506	–7,992	–13,824	–27,259
Equity investments in N.A. affiliates	1,117	3,190	6,062	11,086
Outflow of U.S. equity and debt capital (including trade credit)	–189	–2,710	–3,472	–9,542
Borrowing from N.A. affiliates	–285	–3,715	–5,832	–13,435
Equity investment in N.A. affiliates	96	1,004	2,360	3,893
Earnings of N.A. affiliates[1]	41	202	542	995
Reinvested earnings of subsidiaries	20	186	500	833
Subsidiary dividends & branch profits	21	16	42	162
Inflow to U.S. owners of dividends branch profits & interest[2]	–101	–313	–1,148	–2,721
Dividends and branch profits	21	16	42	162
Interest	–132	–329	–1,190	–2,883

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1. Net of any Netherlands Antilles corporate tax.
2. Net of any Netherlands Antilles withholding tax. Components may not total exactly, due to rounding.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* August 1983, and unpublished tabulations.

terest rates available in Europe relative to the United States, but almost the fact that the number of such affiliates increased. The volume of equity investment in finance subsidiaries increased also as rapidly during the same period, from $1.1 billion to $11.1 billion. The ratio of the inflow of loan capital to the outflow of equity capital was 2.3 in 1978 and 1980 and 2.5 in 1982. The associated interest payments rose from about $130 million in 1978 to nearly $3 billion in 1982.

2. Caribbean direct investments in the United States

Table 7 illustrates the reverse situation of direct investments in the United States by parent corporations organized in particular Caribbean jurisdictions. Such investment increased sharply between 1978 and 1980, both in absolute terms and as a share of all foreign direct investment in the United States. It continued to increase in 1982, but at a slower rate than all such foreign direct investment in the United States.

TABLE 7
Foreign direct investment in the United States from selected Caribbean countries and all countries
1978-1982
($ millions)

	1978	*1980*	*1982*
Bahamas	208	325	374
Bermuda and British Islands[1]	419	888	1,174
Netherlands Antilles	2,412	4,824	6,398
Panama	495	707	951
Sum of Caribbean tax havens	3,534	6,744	8,897
All countries	42,471	68,351	101,844
Netherlands Antilles as a percent of all countries	5.7%	7.1%	6.3%
Other Caribbean tax havens as a percent of all countries	2.6%	2.8%	2.5%

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1. Includes some smaller islands not covered in other tables.

Source: Unpublished figures received from the Office of Business Economics, U.S. Department of Commerce.

The bulk of this investment is attributable to corporations established in the Netherlands Antilles. The data do not indicate the extent to which such corporations are owned by U.S. or third-country shareholders; but the portion of the investment originating in the Netherlands Antilles of which the ultimate beneficial owner is a resident of the Antilles is probably negligible.

As in the case of the Antilles finance subsidiaries of U.S. corporations, the exemption from U.S. tax of interest paid to Antilles recipients under the U.S.–Netherlands Antilles income tax treaty is a significant factor. Residents of countries with which the United States does not have an income tax treaty providing a similar benefit are attracted to the possibility of lending to the United States through an Antilles corporation to obtain the benefits of the tax treaty, the low tax in the Antilles, and the absence of any withholding tax on the remittance of the earnings from the Antilles entity to the foreign (third country) parent. As previously noted, the income tax treaty between the United States and the Netherlands Antilles is under renegotiation. A primary objective of the United States negotiators is to limit the benefits of the treaty to residents of the two countries.

Another important factor in the future use of the Netherlands Antilles treaty by residents of third countries is the proposed legislation (H.R. 4618; S. 1557) to eliminate the U.S. tax on certain payments of interest to non-residents. If enacted, that proposal would remove the current advantage of investing through the Netherlands Antilles with respect to Eurobonds.

3. Payments of U.S. income to residents of Caribbean jurisdictions

Persons making payments of U.S. source fixed or determinable income (e.g., dividends, interest, rents, and royalties) to foreign persons are generally required to withhold U.S. tax[17] and are required to file a return with the Internal Revenue Service indicating the type and amount of income paid and the tax withheld. Tabulations of those returns by the IRS show an unusually large and rapidly rising flow of such payments to Caribbean tax havens, particularly the Netherlands Antilles.

As shown in Table 8, although there were fewer than 2,000 withholding tax returns filed with respect to payments to residents of the Netherlands Antilles in 1981, out of a world-wide total of 575 thousand such returns, the gross income paid to recipients in the Netherlands Antilles amounted to nearly 15% of the world-wide total. By 1981, the Netherlands Antilles accounted for more gross income than any other single country, and the gross income received by residents of the Antilles exceeded that country's gross national product. The average payment per return amounted to about $17,000 world-wide and to about $754,000 for recipients in the Antilles.

A return is filed by each withholding agent for any given recipient. Thus, more than one return would be filed for a recipient receiving income from more than one withholding agent, and it is possible, as a consequence, that the average amount per recipient is higher than that shown in the table (on a world-wide basis, not only for recipients in the Antilles).

Table 8 also indicates that, worldwide, payments to corporations generated only 13% of the returns in 1981 but represented 73% of the gross income. In the Caribbean jurisdictions listed, corporations tended to account for an even higher percentage of the gross income than the world-wide average, but they also represented a much higher proportion of the returns.[18]

Table 9 illustrates the composition of the income payments. World-wide, roughly 45% of the gross income paid to non-residents was dividends, 35% was interest,

17. See Sections 1441 and 1442 of the Internal Revenue Code.
18. For the Bahamas, the share of gross income paid to corporations appears to be substantially less than the world-wide average, but this may be due to the reporting; the largest single category of recipient in the Bahamas is reported as "other", i.e. other than an individual, corporation, partnership, nominee, fiduciary, tax exempt institution, or government.

TABLE 8
Gross income paid to non-residents as reported on Form 1042S
1981

	Gross income ($ '000)	Number of returns	Average payment	Payments to Corporations: % of total returns	Payments to Corporations: % of gross income
World-wide	9,561,489	575,207	$ 16,623	13%	73%
Netherlands Antilles	1,399,528	1,857	753,650	63	95
Bermuda	51,728	1,522	33,987	30	82
Panama	45,966	2,531	18,161	34	64
Bahamas	39,482	1,886	20,934	37[1]	41[1]
Cayman Islands	24,391	718	33,971	65	85

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1. For the Bahamas, the largest single category of recipient, representing another 41% of the gross income payments, was identified as "other" than an individual, corporation, partnership, nominee, fiduciary, government or international organization, tax exempt institution, private foundation and unknown.

Source: Unpublished tabulations of Form 1042S. See also Internal Revenue Service, SOI (Statistics of Income) *Bulletin*, summer 1983, p 35F.

TABLE 9
Composition of U.S. gross income of non-residents as reported on Form 1042S
1981

	Gross income ($ '000)	% OF TOTAL: Dividends	% OF TOTAL: Interest	% OF TOTAL: Other
World-wide	9,561,489	44.6	35.2	20.2
Netherlands Antilles	1,399,528	23.5	74.1	2.4
Bermuda	51,728	37.3	37.1	25.7
Panama	45,966	59.6	24.9	15.5
Bahamas	39,482	45.6	8.6	45.7
Cayman Islands	24,391	14.5	74.1	11.4

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Source: Internal Revenue Service, unpublished tabulations of Form 1042S.

and all other types of payment (e.g., royalties, rentals, and personal service income) accounted for the remaining 20%. There is no single pattern to the payments to the Caribbean jurisdictions. However, it is notable that nearly 75% of the total payments to the Netherlands Antilles and the Cayman Islands consisted of interest. There is a treaty with the Netherlands Antilles which exempts certain interest payments to recipients in the Antilles from U.S. tax. There has never been a U.S. income tax treaty with the Cayman Islands, so the applicable U.S. tax on interest payments to residents of those islands is generally the statutory rate of 30%. In the latter case, such advantages as bank secrecy and tax exemption in the Cayman Islands appear to outweigh the disadvantage of the U.S. tax. However, many of the payments are made to Cayman Island branches of European banks which are residents of countries with which the United States has a treaty exempting interest from tax at source. In those cases, too, there is no U.S. tax advantage to routing the loans through the Cayman Islands, as there would be no U.S. tax if the loan were made directly by the home office. Presumably the secrecy obtained once the funds are in the Cayman Islands is the primary attraction of this indirect approach to lending into the United States.

Table 10 shows the increase in payments of U.S. income to the Caribbean tax havens in recent years. The data only cover a three-year period, from 1978 to 1981. Nevertheless, the payments to the tax havens increased to six times the 1978 level by 1981 while total payments to foreign residents only slightly more than doubled. Again, the Netherlands Antilles dominates the Caribbean figures, both in volume and rate of increase. The uncertainty resulting from the renegotiation of the income tax treaty with the Netherlands Antilles could effect the volume of investment in the United States through the Antilles in 1983.

TABLE 10
U.S. income of residents of Caribbean tax havens as reported on Form 1042S
1978-1981
($ millions)

	1978	1980	1981
Netherlands Antilles	191	632	1,400
Bermuda	21	54	52
Panama	19	39	46
Bahamas	16	22	39
Cayman Islands	9	17	24
Subtotal	256	764	1,561
World-wide	4,451	6,576	9,561
1981 as percent of 1978			
Caribbean jurisdictions			610%
World-wide			215%

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Source: Internal Revenue Service, unpublished tabulations.

4. Ownership of U.S. land

Another aspect of direct investment in the United States is ownership of U.S. land by persons claiming residence in foreign countries. In 1982, residents in the Netherlands Antilles owned 1,039,609 acres of U.S. agricultural land and residents of Panama owned 208,445 acres.[19] Residents of these two countries owned 9.2% of all U.S. agricultural land owned by foreign persons.

C. Currency flows

As noted in Chapter II, one of the most common non-tax criminal uses of tax havens is to launder cash from criminal enterprises which deal in large amounts of cash, particularly narcotics trafficking. The Bank Secrecy Act of 1970 contains three reporting requirements designed to facilitate the detection of such activities. One such re-

19. *Source:* U.S. Department of Agriculture, Economic Research Service, *Foreign Ownership of U.S. Agricultural Land Through 31 December 1983*, Staff Report AGES 830310.

quirement is the Currency Transaction Report (CTR), IRS Form 4789. Except for certain domestic transactions, this form must be filed by financial institutions for each deposit, withdrawal, exchange of currency, or other payment or transfer by, through, or to that financial institution, which involves a transaction in currency of more than $10,000. Multiple transactions by or for any person which in any one day total more than $10,000 are to be treated as one transaction. The information from CTRs is processed by IRS and forwarded to Customs for inclusion in the Treasury Enforcement Communications System (TECS).

Table 11 provides data for selected countries by address of the person making the transaction reported on the CTR. Only three Caribbean Basin countries, the Bahamas, the Cayman Islands, and Panama, were involved in transactions totaling more than $50 million in 1982. All three countries show large deposits and negligible withdrawals.

TABLE 11
Currency transactions reported on Form 4789
Selected countries
1982

($ millions)

	Deposits	*With-drawals*	*Net currency balance deposits less with-drawals*	*Undefined "other" currency transactions*
Caribbean Basin Countries				
Bahamas	153	2	151	14
Cayman Islands	63	*	63	4
Panama	88[1]	3[1]	85	17
Other countries				
Argentina	516	726	–210	318
Canada	80	116	– 36	131
Colombia	121	3	118	13
Mexico	310	508	–198	610
Switzerland	72	85	– 13	103

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* Less than 0.5.

1. Does not include approximately $1 billion in deposits and $100 million in withdrawals through Federal Reserve offices.

Five countries outside the Caribbean Basin are included in Table 11 in order to provide some basis for comparison: Argentina, Canada, Colombia, Mexico, and Switzerland. All show a high volume of transactions, some of which can be explained by proximity to the United States (Canada and Mexico) and economic uncertainty (Argentina and Mexico); but only Colombia shows the large excess of deposits over withdrawals which characterizes the three Caribbean jurisdictions. It seems unlikely that either the magnitude of the flows or the imbalance between deposits and withdrawals for the Bahamas, the Cayman Islands, Panama, and Colombia can be explained as being solely the result of legal activities such as tourism.

The Panamanian transactions with the Federal Reserve[20] are unusual because about 50% of the dollar value was in $20 or lower denomination bills. According to the reports, the smaller denomination bills are usually a minor factor in international transactions. The primary exceptions are Mexico and Canada (presumably the result of tourist activity) and Panama and Colombia (presumably not the result of tourist activity).

Another source of information on the flow of money to and from the United States is the Report of International Transportation of Currency or Monetary Instruments (CMIR), Customs Form 4790. CMIRs are required to be filed by each person who exports from the United States or imports to the United States currency or other monetary instruments exceeding $5,000. The forms are processed by Customs, and the information from them is included in TECS.

A third requirement of the Bank Secrecy Act is that any person who owns or controls a foreign financial account must declare such ownership or control a foreign financial account must declare such ownership or control on that person's federal income tax return and also file Treasury Form 90-22.1.

These requirements were intended, inter alia, to disrupt the laundering and outflow of cash from criminal enterprises. From the inception, it was recognized that enforcement might be difficult. As the Senate report on the 1980 Act observed:

> Reports are not a foolproof method of preventing organized crime from sending currency out of the country. Obviously, a criminal who is already breaking the law could just as easily ignore the reporting requirement. The significance of requiring reports is that it provides the Justice Department with another means of obtaining a conviction.[21]

D. Revenue effect

This chapter has provided data on financial activity in the Caribbean Basin. The topics covered have included banking, U.S. direct investment in the Caribbean, Caribbean direct investment in the United States, and currency flows involving Caribbean persons. Chapter IV represents several examples of criminal use of tax havens which resulted in the loss of revenue to the United States. Clearly, an estimate of the revenue lost as a result of the abuse of tax havens would be useful in evaluating the appropriateness and cost-effectiveness of various proposals to curb such abuse. But because of the conceptual and measurement problems described in this section, a revenue estimate is not presented in this report.

There are two major obstacles which must be overcome in developing an estimate of the revenue loss attributable to the use of tax havens. The first problem is conceptual – defining exactly what is meant by "revenue loss attributable to the use of tax havens." The second problem is practical – obtaining the data required for computing the revenue loss.

Estimates of revenue loss are generally statements of how much additional revenue would be generated if a

20. See footnote 1 of Table 11.
21. Senate Report 91-1139, p. 7.

particular provision of the tax code were repealed, such as the revenue cost of the investment credit or of the mortgage interest deduction. Occasionally, the revenue costs are related to non-compliance with existing provisions of the Code, such as the revenue loss associated with underreporting of interest or dividend income.

The amount of revenue loss for the examples described above would be computed by comparing collections under the current law (or level of enforcement) with collections under some other set of conditions (such as repeal of the investment credit). In determining the revenue loss attributable to the use of tax havens, the question arises as to what the other set of conditions might be. In Chapter II, it was noted that for U.S. taxpayers, tax havens, in and of themselves, do not generally provide a U.S. tax advantage. The U.S. tax advantage generally is provided only in combination with the U.S. system of deferral of taxation of retained earnings of foreign corporations, the U.S. system of foreign tax credits, and any applicable treaty. Yet a revenue estimate of the loss attributable to the use of tax havens, deferral and the foreign tax credit would have little value in this context.

A similar problem arises in trying to assess the revenue implications of modifying a treaty. For 1982, nearly $1 billion of U.S. interest was paid to recipients in the Netherlands Antilles free of U.S. tax under the United States–Netherlands Antilles income tax treaty. However, since the reduction in U.S. tax occurs in accordance with U.S. law, there is an associated revenue loss only to the extent that such interest would have paid a U.S. tax in the absence of the treaty exemption. If the treaty were amended to impose a tax on interest paid to the Antilles, there would be fewer loans made through the Antilles. There may be little revenue gain because of the existence of other treaties exempting interest payments from tax at source. Further, if the legislative proposal to repeal the U.S. tax on certain Eurodollar obligations is enacted, there may be additional ways to engage in such transactions free of tax on the interest payments.

Nor could we conclude that the revenue lost through the use of Caribbean tax havens could be recovered through measures aimed only at that region. Just as there are often alternative statutory and treaty provisions, there are also alternative tax havens.

Perhaps the clearest loss of revenue is attributable to transactions on which U.S. tax is being evaded, i.e. on which tax is due under existing law. However, much of that revenue loss is probably due more to the evasion of other laws, i.e. to cases where income is not reported for tax purposes to conceal that the income was acquired illegally.

Even if a definition of the revenue loss attributable to tax havens could be developed, it would be extremely difficult to produce an accurate estimate. Most of the information we have concerning the use of tax havens is indirect. The data provided in Chapter III show that tax havens have disproportionately large financial sectors and that surprising amounts of funds are channelled in and out of the United States through tax havens. Chapter IV includes several examples of specific tax haven related activities. It seems likely that a substantial part of the activities measured in Chapter III reflect operations similar to those described in Chapter IV. Moreover, it is reasonable to expect that the use of tax havens also reduces the U.S. tax base through increased deductions. (For example, to enjoy the use of funds sheltered in tax havens, U.S. owners may arrange loans from their tax haven entities and deduct the interest payments on their U.S. returns.) However, there is no way to estimate either the fraction of such activities which result in a revenue loss to the United States or the tax consequences of such activities.

CHAPTER IV
ANTI-TAX HAVEN ACTIVITIES

This chapter describes the anti-tax haven activities undertaken by the Treasury Department, the Internal Revenue Service, and the Justice Department to combat illegal rises of tax havens.

A. Criminal enforcement activities

1. Statistical data

The Internal Revenue Service's criminal investigation function has identified 464 cases for the period January 1978 through August 1983, containing financial transactions allegedly involving Caribbean Basin countries. The term "allegedly" is used because, in some cases, financial ties to a Caribbean Basin country could not be corroborated. An analysis of these cases shows that:

(1) Approximately 55% involve illegal income (161 cases involving narcotics traffic). Of that 55%, 90% involve four countries: the Cayman Islands (29%), Panama (28%), the Bahamas (22%), and the Netherlands Antilles (11%).
(2) The remaining 45% involve legal income (91 cases involving tax shelters, 25 involving tax protesters). Of that 45%, 85% involve five countries: the Cayman Islands (36%), the Bahamas (19%), Panama (15%), Bermuda (9%), and the Turks and Caicos Islands (6%).
(3) Overall, 85% involve four countries: the Cayman Islands (34%), Panama (22%), the Bahamas (21%), and the Netherlands Antilles (8%).

The status of the 464 cases is as follows:

(1) 130 are under active investigation;
(2) in 153, prosecution has been recommended;
(3) in 81, prosecution has been successful on various tax charges including conspiracy and Bank Secrecy Act violations; and
(4) 100 have been discontinued or declined for various reasons (including 36 instances because records from tax haven jurisdictions were unavailable).

Although some of the 81 cases in which prosecution was successful did not result in an increase in taxable income, and detailed information was not available for others, at least 42 of these cases resulted in an increase in taxable income. The average increase in taxable income for these 42 cases is about $1.7 million, ranging from a high of about $10 million to a low of about $20,000.

2. Examples

Perhaps the best way to understand how tax havens work and why they are attractive is to examine specific operations. Both the Gordon and the Senate reports provided numerous examples of the use and abuse of tax havens. The cases included in this section are simply more recent examples.

The cases are grouped into four broad categories: (1) international business; (2) tax shelters; (3) tax protesters; and (4) narcotic and dangerous drug traffic.

(1) *International business*

The U.S. government successfully prosecuted an international business fraud in the case of *United States* v. *Norman Johnson*, No. 82-405 (E.D. La.). Johnson was chairman of the board of directors of Lucey Products Company, a firm engaged in the purchase and sale of oil field pipe and related equipment. During 1974, Johnson and another individual used nominees to organize two Bermudian corporations, their ownership of which was concealed. Lucey Products then sold equipment to the Bermudian corporations at less than market prices. The Bermudian corporations resold the equipment to unrelated companies at substantially higher (market) prices. Profits from the sales were deposited at Bermudian, Canadian, and Cayman Islands banks in accounts maintained in the names of Lucey Products, the two Bermudian corporations, and certain fictitious names. The deposited funds were subsequently withdrawn and used for the personal benefit of Johnson and the other individual. Lucey Products did not disclose its relationship to the Bermudian corporations on its corporate income tax returns. The Bermudian corporations did not file corporate income tax returns in the United States or any other country. Neither Johnson nor the other individual reported the profits on their individual income tax returns. In total, Johnson failed to report taxable income of $7,028,000 during the years 1975 through 1979. On 15 October 1982, Johnson entered a plea of guilty to a single count – conspiracy to defraud the United States by impeding and impairing the Internal Revenue Service in the assessment and collection of the revenue. On 18 February 1983, Johnson was sentenced to a term of five years imprisonment.

The government is prosecuting a major international business fraud in the case of *United States* v. *Marc Rich, et al*, No. 83 Cr. 579 (S.D. N.Y.). On 19 September 1983, a federal grand jury returned a 51-count indictment charging the defendants with attempting to evade $48 million in U.S. tax liability. The indictment alleges that the income on which the evasion charge is based was earned through manipulation of the U.S. regulated crude oil market. During 1980 and 1981, crude oil sellers operated under government imposed price controls. To circumvent these controls, the Swiss oil-trading parent corporation and a Swiss subsidiary engaged in oil trading in the United States used "daisy chains" to "convert" oil regulated for sale at a low price either into oil regulated for sale at a higher price or into unregulated oil for sale at an uncontrolled (world market) price.

Tremendous profits were generated upon resale made or controlled by the subsidiary operating in the United States to a third party buyer at arm's length prices. These profits were subject to U.S. income tax, but to secure a tax advantage, the profits were hidden on the books of a domestic oil-trading company acting on behalf of the subsidiary and then transferred offshore to the Swiss parent. This was accomplished, again, through sham and artificially priced oil purchase and sale transactions between the Swiss parent and the surrogate company of the subsidiary.

As a result, the profits were not reported on the subsidiary's books for United States tax purposes. Although public attention has been focused on the Swiss subsidiary operating in the United States and its Swiss parent, two wholly-owned Panamanian subsidiaries of the Swiss parent served as conduits to transfer the profits offshore. Another unrelated series of transactions creating fictitious losses involved the Swiss parent and its subsidiary and a Bahamian subsidiary of another oil-trading company.

(2) *Tax shelters*

In *United States* v. *Verland T. Whipple, et al*, CR81-00036-01J (D. Utah 1981), aff'd, No. 81-2459 (10th Cir. 1983), tax shelter promoters utilized tax haven jurisdictions to conceal from the IRS the illusory nature of transactions generating millions of dollars in fraudulent tax benefits. When the Tax Reform Act of 1976 eliminated non-recourse notes in motion picture investments, Whipple, a fraudulent motion picture tax shelter promoter since the early 1970s, devised a new scheme to create fraudulent recourse notes. Investors in a limited partnership contributed cash to the partnership and signed a recourse note to the Bank of Canvi Andor, a shell bank in Andorra, in an amount three to five times that of the cash contribution. The partnership then entered into a movie distribution contract with United Media Management and Consultants (UNIMAC), a shell movie service company in the Cayman Islands, calling for the partnership to pay an amount which generally equaled the total of the investors' cash and the promissory notes to the Bank of Canvi Andor. The bank then "loaned" funds generated by the investor notes to the Cayman distribution company.

In fact, no funds ever went to or left the "bank" and the investors' cash was merely laundered through the Cayman entity. Since both Andorra and the Cayman Islands have bank secrecy laws, the IRS was unable to verify representations of the promoters contained in documents provided during an audit. However, "insider" witnesses privy to the scheme provided documents and testimony sufficient to establish the true nature of the operation. Thus, the Government was able to present sufficient evidence to convict Whipple and two others for aiding and assisting in the preparation of false partnership and investors' returns; Whipple was sentenced to a two-year term of imprisonment.

United States v. *Carruth and Reed,* 699 F.2d 1017 (9th Cir. 1983), is another example of a tax shelter prosecution. Thomas A. Carruth and Jackson L. Reed, as promoters of numerous cattle-breeding limited partnerships, promised at least 450 investors a legal tax deduction in excess of cash invested each year. Leverage for the promised deduction, from the purchase of cattle feed, allegedly came from loans made by a Canadian corporation owned and controlled by Reed.

In fact, no loans existed and the transactions giving rise to deductions by 119 limited partnerships were nothing more than a "check circle". The "lender" wrote checks on a given date to the limited partnerships. On that same day the partnerships all of which maintained accounts at the same Canadian bank as the "lender", wrote checks to a cattle feed company in the same aggregate amount as the aggregate amount of the "loan" checks. The cattle feeder also wrote a check in the equivalent aggregate amount to the "lender". No money changed hands, yet substantial documentation was generated to prove nonexistent loans and cattle feed purchases. This procedure occurred on 21 separate occasions and created deductions in excess of $10 million. The investors' cash was siphoned off by the promoters. Carruth deposited his in Mexican and Bermudian bank accounts. Bank statements of these accounts were secured and admitted into evidence during the trial. Both defendants were convicted of conspiracy to defraud the United States.

(3) *Tax protest*

The case of *United States* v. *Karl L. Dahlstrom, et al,* 713 F.2d 1423 (9th Cir. 1983), involved the use of foreign trusts to evade taxation. The American Law Association (ALA), of which Dahlstrom was founder and president, conducted seminars in which ALA memberships and "tax education packages" were sold for substantial fees. The packages included forms for establishing foreign trusts in the Turks and Caicos Islands and Belize. The package purchaser, upon advice from Dahlstrom or others conducting seminars, set up several foreign trusts, purportedly purchased goods or services from one of the trusts, and claimed an income tax deduction for the full amount of payments to that trust as business expenses.

However, through a series of transactions involving the trusts, all or a significant portion of the amount claimed as a deduction was returned to the purchaser as a "gift" or "loan". Thus, the taxpayer's actual expenditure was entirely fictitious or, at best, less than the amount claimed as a deduction on his income tax return. The scheme, in existence from May 1976 to January 1980, is conservatively estimated to have sold at least 700 packages nationwide, which resulted in at least $7 million in unreported tax liability.

In January 1982 the defendants were convicted of conspiracy to defraud the United States by impeding and impairing the IRS in the assessment and collection of the revenue as well of aiding and assisting in the preparation of false individual income tax returns. In August 1983 in a two-to-one decision which may have significant adverse impact on the government's tax enforcement program, the Ninth Circuit Court of Appeals reversed the convictions, holding that the evidence was insufficient to sustain them. Focusing on the validity of foreign trusts rather than on the sham transactions in which the trusts were involved, the majority stated that, as it was "convinced that the legality of the tax shelter program advocated by the appellants was completely unsettled by any clearly relevant precedent on the dates alleged in the indictment", the defendants lacked the requisite knowledge to violate the law. The majority also held that the First Amendment of the United States Constitution protected the defendants' activities. In a strongly worded dissent, Judge Goodwin stated that the law governing the types of transactions involved in the instant case was well settled and that the defendants' actions demonstrated specific awareness of the illegality of the conduct. He further noted that no violation of First Amendment protected speech or association occurs where the communications involved are part of a conspiracy to commit unlawful acts. The United States is considering a petition for a writ of certiorari.

In *United States* v. *Anderson, et al,* CR83-013 (D. Wyo.),[22] a grand jury on 24 February 1983 indicted the defendants, including the First Colonial Trust, Ltd., a financial institution organized under the laws of the Turks and Caicos Islands, for conspiracy to defraud the United States by impeding and impairing the IRS and for other tax crimes. The indictment alleges that the defendants promoted and sold so-called "common law trusts" to various individuals for substantial fees ranging from $750 to $20,000. The trust package purchasers were provided with preprinted forms for setting up common law trusts in the United States and the Turks and Caicos Islands.

The purchaser, upon the advice and counsel of one or more of the defendants, then entered into a series of transactions designed to assign income or to transfer personal and business assets to the trust. The purchaser was able to maintain control over the income thus assigned or the assets thus transferred, and exercise that control in an atmosphere of secrecy, because the "independent" trustee, defendant First Colonial Trust, was a foreign entity which operated pursuant to the purchaser's instructions. In fact, the purchaser held the trustee's undated presigned resignation letter to insure that the purchaser could regain complete title and control at any time. On 20 October 1983 U.S. District Judge John L. Kane, Jr., dismissed the indictment after finding that the government's actions during the grand jury's investigation "obfuscated the important constitutional distinction between prosecutor, law enforcement investigator, and grand jury" and, thus, impaired the independent judgment of the grand jury. On 17 November 1983 the United States filed a Protective Notice of Appeal.

(4) *Narcotics and dangerous drugs*

The Government prosecuted a major narcotics trafficker in the case of *United States* v. *John English,* MCR82-00215 (N.D. Fla.). On 5 October 1983 the defendant pled guilty to a single count of attempting to evade $161,233 in U.S. income tax liability for 1978 as well as to a controlled substance charge. The investigation revealed that the defendant laundered substantial amounts of narcotics-related income through property acquisitions in Jamaica and the Bahamas. As part of his plea agreement, the defendant agreed to forfeit $1.2 million in assets to the Government.

In the case of *United States* v. *Ryals, et al,* No. 83-60-CR-J-16 (N.D. Fla.), the defendants conducted a marijuana

22. This case has been dismissed; further action is under consideration.

farming operation and controlled sale and distribution of the crops therefrom. Significant revenues were generated during 1975 through 1979. To conceal the source of his funds, defendant Ryals formed a U.S. corporation, Solar Energy Products, Inc. This entity operated as a legitimate, ongoing business. Thereafter, he formed a Cayman Islands corporation called Solar Energy Products, Ltd. This entity was a shell corporation, the sole function of which was to launder money. Drug money was funneled through the shell corporation and returned to the U.S. corporation or directly to the defendant as business payments and loans in sufficient amounts to cover the substantial amounts of currency the defendant had earned during 1975 through 1979. During September and October 1983 all defendants save one entered pleas of guilty to various tax and narcotics violation charges.

B. Civil enforcement activities

This section provides brief descriptions of current anti-tax haven activities of the Treasury Department.

1. Legislative initiatives

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made a number of changes to the Internal Revenue Code designed to improve taxpayer compliance. The addition of Section 982 and 6038A and modification of Section 6038 may affect persons who use tax havens.

As noted earlier in this report, the proper administration of the tax law often requires that the IRS have access to books and records which are not always available. To discourage taxpayers from delaying or refusing disclosure of certain foreign-based information to the IRS, Section 982 was added to the Internal Revenue Code. This section creates a new document called a "Formal Document Request". Taxpayers must respond to a Formal Document Request within 90 days, unless reasonable cause is established, or the documentation cannot be introduced into any subsequent civil court proceedings.

Section 6038 of the Code requires that a U.S. taxpayer that owns, directly or indirectly, 50% or more of a foreign corporation report certain transactions that the foreign corporation has with the taxpayer (as well as transactions that the foreign corporation has with corporations controlled by the taxpayer, or any U.S. person owning 10% or more of the stock of the foreign corporation). The transactions reported include sales and purchases of stock in trade, purchases of property rights (including patents, trademarks, etc.), and receipts from and payments of compensation, commissions, rents, royalties, license fees, dividends, interest and premiums for insurance. Under prior law, the sole civil penalty for failure to furnish any required information was a 10%-reduction of the U.S. person's creditable foreign taxes. Under this penalty, additional 5%-reductions were provided if the failure to furnish information continued 90 days or more after notice to the U.S. person required to furnish the information.

Despite concern about inadequate reporting with respect to controlled foreign corporations, penalties generally were not imposed. In part, this was because the penalty was complicated. It also may have been unduly harsh in some cases, because a taxpayer could incur a substantial penalty for a minor failure. A penalty reducing creditable foreign taxes obviously has no effect if the U.S. person required to report paid no foreign income taxes during the year in question. TEFRA expanded the penalties by adding a fixed-dollar penalty for failure to furnish information under Section 6038. The penalty is $1,000 for each failure to furnish information. If the failure continues for more than 90 days after notification, there are additional $1,000-penalties for each 30-day period (or fraction thereof) with a maximum for any one annual accounting period of any one controlled foreign corporation of $25,000.

Section 6038A of the Code, also added by TEFRA, requires domestic corporations and foreign corporations engaged in a trade or business in the United States that are controlled by a foreign person to provide information with respect to transactions with a foreign corporation that is under common control with the taxpayer. Though regulations have not been promulgated under Section 6038A, it is probable that the same kinds of transactions that must be reported under Section 6038, described above, will have to be reported under Section 6038A. This requirement also imposes penalties for violation of this new reporting requirement that are similar to the new supplemental penalties in Section 6038.

Other legislative changes relate to tax treaty policy and enforcement. Section 342 of TEFRA directs the Treasury Department to consider methods of reducing abuse of tax treaty benefits. The Caribbean Basin Initiative legislation seeks to encourage the negotiation of exchange of information agreements. These issues are discussed in Section D of this Chapter.

2. International examinations

a. *Identification of potential tax haven activity*

The IRS has recognized the serious problems of tax avoidance and evasion through transactions involving tax havens. Each year the Service's Assistant Commissioner (Examination) issues examination program guidelines, known as the Examination Program Letter, to highlight those areas most in need of attention and emphasis. In fiscal years 1983 and 1984, identification and examination of returns filed by taxpayers using tax havens have been treated as top priorities in the Examination Program Letter and, as such, have received special emphasis in examination activities.

Changes have been made to Internal Revenue Manual procedures to emphasize the identification and classification for examination of returns with potential tax haven activity. All returns with potential tax haven activity are screened by international examiners, who have extensive training and experience in international taxation, and the acceptance without examination of any of these returns requires management authorization.

b. *Increased resources for examination*

The Assistant Regional Commissioners (Examination) have been authorized to increase their staffing of international examiners from 237 to 326. The number of key districts for international examiners has been increased to 16 with the recent addition of Boston, Philadelphia, Atlanta, and Oklahoma City.

IRS agents have also received increased training to assist them in identifying and understanding various methods used by taxpayers to avoid or evade taxes by using tax havens. This training has not been limited to international examiners, but has been provided to all agents in both specialized and general program groups. In addition, seminars in international tax law have been conducted for IRS executives, with emphasis on tax havens.

3. Special examinations

Examination has initiated a project involving the Currency Transaction Report (CTR) and the Report of International Transportation of Currency or Monetary Instrument (CMIR) files contained within the Treasury Enforcement Communications System (TECS) data base to:

- Gather and analyze information for the purpose of identifying taxpayers involved in large currency transactions, and taxpayers transporting currency from tax haven countries; and
- Disseminate the information analyzed to the field for the initiation of civil examinations.

Since 1980, CTRs have been included in two IRS programs where the documents are matched with income tax returns. These documents are then used in a screening program for selecting returns for examination. Based on experience to date, the IRS has taken the following actions to improve the CTR screening program:

- A program change was made, effective 1 January 1983, which will identify the actual owner of funds involved in the transaction reported on the CTR. Previously, couriers carrying out the transaction were identified as the owner.
- A system is being developed to screen and classify CTR transcripts which cannot be matched with tax returns, in an effort to identify individuals who have a requirement to file an income tax return but have not done so.

4. Tax haven information book

In February of 1982, the IRS issued its "Tax Haven Information Book" (Document 6743), which detailed the information available about some 30 tax haven countries. Copies of the book were provided to IRS agents in the field, as well as other concerned federal agencies, for their use. The book proved to be such a valuable reference tool that a new, expanded edition is being prepared for issuance by the end of this year. The new edition will include more information on more countries than the previous version.

C. Information-gathering task force

In response to the ever-increasing and difficult problems encountered by the IRS in dealing with the use of tax haven financial institutions and business entities by U.S. taxpayers, the Criminal Investigation and Examination functions formed a joint information-gathering project in May 1983 which has been designated "Project Tax Havens – Offshore Banks". The objective of the Project is to identify U.S. taxpayers who are utilizing the facilities of tax haven countries to establish business entities and bank accounts which are protected by stringent foreign secrecy laws and are using these vehicles for the purpose of evading income tax. The Project is planned as a three-phase operation.

The initial, and current stage, is the identification and acquisition of as much information and documentation as possible from the widest variety of sources which will contribute to the identification of potential tax evaders. From within IRS, numerous documents, returns, files and computer tapes which contain information that will assist in identifying individuals and corporate taxpayers of interest to the Project have been located. Contacts with other governmental agencies have also produced a great deal of potentially useful information.

Once all available intelligence has been gathered, it will be formatted for maximum computer applications. The information will then be reviewed, analyzed, and matched for the identification of potential targets for investigation and examination. All identifications of interest will be cross-checked on existing law enforcement and other computerized information systems.

The final phase of the Project's effort will be the preparation of referrals of information "packages" containing comprehensive and substantive leads of potential tax violations to field offices for possible criminal investigations or civil examinations.

D. Tax treaty policy

In addition to these extensive enforcement activities of the IRS, the Treasury Department has been dealing with the problems of tax haven abuses, in the Caribbean and elsewhere, through its tax treaty policy.

1. General U.S. tax treaty policy in regard to tax havens

Tax treaties are mechanisms for dividing taxes on international transactions between two countries that have authority to tax: the country of the source of the income and the country of residence of the recipient. As the official titles of U.S. tax treaties state, treaties are intended (a) to prevent double taxation and (b) to prevent avoidance and evasion of the tax of the two countries.

An income tax treaty is a contract between two countries and is designed to restrict benefits to the residents of those two countries. The objective is to exclude residents of third countries from treaty benefits. This basic purpose is implemented in the tax treaty policy of the United States by the use of provisions to combat "treaty shopping".

Treaty shopping, in essence, is the ability of residents of countries other than the countries that are parties to the treaty to derive treaty benefits (such as rate reductions on passive income) by channeling investments through entities in a treaty jurisdiction.

It is Treasury Department policy not to enter into new treaties which permit the unwarranted granting of benefits to residents of third countries and, as appropriate, to renegotiate, or, if necessary, to terminate, existing treaties to accomplish this objective. Limitation of benefits provisions (which define the permissible classes of treaty beneficiaries) are employed wherever necessary, and in the form appropriate to the circumstances, to ensure that U.S. policy goals are met by limiting the extension of benefits in U.S. tax treaties. This policy cannot be applied inflexibly. In view of the wide range of international economic relationships and the diversity of foreign tax systems, there is no single model limitation of benefits provision; each treaty relationship is approached separately.

The limitation of benefits policy has several objectives. First, curtailment of "treaty shopping". Treaty shopping results in tax avoidance because treaty benefits are obtained by unintended beneficiaries who do not reside in a treaty country, but channel their investment through entities formed in such a country.

Second, expansion and improvement of the U.S. tax treaty network. Use of treaties by third-country residents makes it more difficult for the United States to conclude treaties directly with those third countries. If residents of these countries can enjoy U.S. treaty benefits by the simple and inexpensive expedient of establishing an entity in an appropriate U.S. treaty partner jurisdiction, their countries of residence have little incentive to enter into treaties with the United States. Since such treaties would reduce foreign taxes on U.S. taxpayers, the result is higher taxes abroad for U.S. businesses. The same issue arises with respect to existing treaty partners. If, for example, there is a 15% withholding tax on interest in an existing treaty, which the United States would like to reduce, reciprocally, to zero, that country is under little pressure to agree to such a change if its residents can receive a zero U.S. tax rate by investing in the United States through an entity formed in another jurisdiction which has entered into a treaty with the United States.

Third, adherence to the letter and spirit of the law. Use of tax treaties by third country residents violates the coherence of the Internal Revenue Code. For example, the Code provides for a 30% tax to be imposed on payments of U.S.-source passive income to foreign persons, except where a tax treaty provides for a reduced rate on a reciprocal basis. If any foreign investor can avoid that tax by interposing a treaty-protected entity, then that treaty has, in effect, replaced U.S. internal law. Such a process erodes confidence in the integrity of the U.S. tax system. If Congress wishes unilaterally to repeal or modify the present statutory tax, that should be done explicitly, by both houses of Congress, and not by improper use of a tax treaty.

2. U.S. tax treaty policy with respect to Caribbean tax havens

The potential for abuse of tax treaties is a matter of concern; however, the degree of concern varies significantly from treaty to treaty. In negotiating a treaty with a country that has a high effective rate of tax on the income of its residents and that has withholding taxes on payments to non-residents (i.e. generally a non-tax haven), the Treasury has considerably less concern than it would have in a treaty with a country that imposes a low effective tax burden on its residents (or on certain classes of residents or income, such as resident entities that do business offshore or certain dividend income from subsidiaries) and that has no withholding taxes on payments of income to non-residents. The latter case exemplifies a tax haven treaty partner.

While the United States would not presently enter into a new treaty relationship with a tax haven, unless the potential for abuse was significantly proscribed and substantial real economic relations exist between the United States and that country, it has or has had tax treaties with several Caribbean jurisdictions that are generally acknowledged to be tax havens. This results largely from historical accident; during the 1950s, U.S. tax treaties with several European partners were extended to a number of overseas dependencies of the European countries. Some of these Caribbean jurisdictions have become tax havens and have been exploiting their tax treaties with the United States.

There are several options available in dealing with existing tax haven treaties. The United States can renegotiate these treaties to eliminate the potential for abuse; it can terminate the treaties and not replace them; or it can terminate the treaties and seek to negotiate a new treaty on satisfactory terms. The Treasury has taken, or is prepared to take, each of these approaches, as appropriate, in individual cases.

In early 1981, a new treaty was signed with the British Virgin Islands (BVI) to replace the extension of the U.S.–U.K. treaty to the BVI, which treaty was becoming increasingly subject to abuse. On reflection, the present Administration determined that the new treaty, while reducing the opportunity for abuse by third-country residents, remained susceptible to a continuing and not insignificant level of potential abuse, and should, therefore, not enter into force without amendment. The ensuing efforts to renegotiate that treaty to insert a sufficiently restrictive limitation on benefits provision were not successful. The negotiations were suspended and the existing treaty, which had remained in force, was terminated as of 1 January 1983.

On 1 July 1983, the Treasury announced that notices of termination had been sent to a number of jurisdictions to which the U.K. and Belgian treaties had been extended, including nine U.K. extension treaties in the Caribbean Basin area.[23] These terminations will be effective as of 1 January 1984. Several of these jurisdictions are tax havens which were exploiting third-country use of their treaties with the United States. In those cases where it is judged appropriate to do so, the United States is prepared to enter into negotiations with these jurisdictions on new treaties which would, at the same time, more adequately reflect those countries economic relationships with the United States, and insure against abuse of the treaty.

Yet another approach has been taken with the Netherlands Antilles. Negotiations have been ongoing for several years on a new treaty which would deal with most

23. Anguilla, Barbados, Belize, Dominica, Grenada, Montserrat, St. Christopher-Nevis, St. Lucia, St. Vincent, and the Grenadines.

forms of third-country use of the treaty. The present treaty has remained in force while the negotiations have proceeded. It is the intention of the Treasury Department that the United States will have no tax treaties in force with Caribbean tax havens that are subject to abuse.

To assure both that the benefits of U.S. tax treaties are received only by persons properly entitled to them, and that the IRS has the information necessary to enforce U.S. tax laws with respect to any transactions which may take place within the jurisdiction of a tax haven treaty partner, any such treaties as may exist will have comprehensive exchange of information provisions.

3. Legislative initiatives pertaining to tax treaty policy

a. *Prevention of abuse of tax treaty benefits*

Under present law, a recipient of U.S. source dividends who has an address in a country with which the United States has a tax treaty which provides for a rate reduction with respect to such income will, with limited exceptions, be presumed to be a resident of such country for purpose obtaining reduced rates of tax on such dividends. With respect to interest and other types of fixed or determinable passive income, a foreign taxpayer may obtain a rate reduction by certifying his eligibility for treaty benefits to the withholding agent. Both of the methods of obtaining reduced rates of tax under a treaty are subject to abuse, and particularly so with regard to payments to residents or addresses in tax haven treaty partners.

Section 342 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") was enacted in response to concerns regarding such abuse. Section 342 directs that procedures be designed to prevent the kind of abuse that occurs through the improper use of nominees and other conduits that pass U.S. source income through to a person who is not a bona fide resident of the treaty country.

A number of alternatives to the present enforcement system are available, including the adoption of a refund system of withholding tax on passive income. A refund system would require withholding agents to withhold U.S. tax at the statutory 30% rate on all U.S. source fixed or determinable passive income paid to foreign persons, regardless of the potential application of a treaty provision reducing the 30% rate or eliminating the tax altogether. The foreign recipient who claims treaty benefits would then be required to file a claim for a refund on an annual tax return. Supportive documentation would be required. Another approach, the "certification system", would require the foreign recipient to file a certificate of residence furnished by the competent authority of the country whose treaty benefits are being sought. Pursuant to the mandate of Section 342, the Treasury is considering such stricter procedures.

b. *Requirements for exchange of information agreements*

Prevention of tax avoidance and evasion is a basic goal of tax treaties; therefore, exchange of information provisions are an important part of tax treaty policy. The CBI legislation contains provisions designed to foster negotiation of executive agreements for the exchange of information with the countries of the Caribbean Basin.

The principal U.S. tax benefit provided to countries of the Caribbean Basin under the CBI legislation is the allowance to U.S. taxpayers of deductions for ordinary and necessary expenses of attending business conventions held in CBI beneficiary countries without a showing that it is as reasonable to hold the convention in that country as in the "North American Area".[24] To qualify for this benefit, in addition to meeting the standards for CBI beneficiary countries generally, a country must enter into an agreement with the United States to exchange tax information. Thus, countries of the region will have to be willing to cooperate with the IRS in tax administration and enforcement in order to benefit from the convention tax deduction provisions of the CBI legislation. This is of particular importance with respect to the tax haven jurisdictions of the Caribbean Basin. In addition to the substantive benefits to U.S. tax compliance efforts which would flow from such agreements, this provision of the statute sends a clear message to other countries of the seriousness with which the United States views the problems of tax avoidance and evasion through transactions involving tax havens.

The CBI legislation authorizes the Secretary of the Treasury to negotiate and conclude the exchange of information agreements. While the Secretary is accorded discretion regarding the kinds of information to be included within the scope of the exchange of information provisions, the legislation imposes certain minimum standards for such agreements. The exchange of information provisions in the agreements must include within their scope tax information (both civil and criminal as such is defined under U.S. law) pertaining to U.S. taxpayers, residents of the CBI country, and "third-country persons", that is, nationals or residents of countries other than the United States or the CBI country that is a party to the agreement. A jurisdiction with restrictions on disclosure of information regarding such third-country persons or otherwise having financial secrecy laws would have to agree that those restrictions and laws would be modified by the agreement in order for it to obtain the tax benefits of the CBI.

A special rule provides for modified standards for exchange of information agreements in certain cases. This rule allows the requirement that the exchange of information agreement supersede provisions of local law regarding bank secrecy and non-disclosure of ownership of bearer shares to be waived in the case of information sought only for civil tax purposes if the Secretary of the Treasury determined that such an exchange of information agreement satisfying the modified standards would assist the administration and enforcement of U.S. tax laws, and if the President determines that such an exception to the standards for exchange of information agreement is in the national security interest of the United States. The override of local law provisions relating to bank secrecy and non-disclosure of the ownership of bearer shares would continue to be required with respect to all criminal tax cases. In addition, all information rele-

24. The "North American Area" means the United States, its possessions, Canada, Mexico, and the Trust Territory of the Pacific Islands.

vant to tax matters not subject to financial non-disclosure provisions would continue to be required to be supplied.

4. Other tax treaty policy activities

The United States, through Treasury Department representatives, has taken a lead role in work-in-process in the Organization for Economic Cooperation and Development (OECD) which bears on the use and abuse of tax havens, in the Caribbean and elsewhere. Working parties of the Committee on Fiscal Affairs of the OECD have been studying tax haven problems generally, and, more specifically, abuse of tax treaties with tax havens. Reports on these subjects are now in preparation with substantial U.S. contributions. The Committee has also been doing extensive work on the exchange of information under tax treaties which, while not specifically related to tax havens, clearly bears on efforts to curb their use. Similar work on combatting tax haven abuse has occurred in the Group of Four (France, Germany, the United Kingdom, and the United States) and the Pacific Association of Tax Administrators (Australia, Canada, Japan, and the United States.)

CHAPTER V
SUMMARY AND CONCLUSIONS

A. Purpose of the Report

The Caribbean Basin Economic Recovery Act requires that the Secretary of the Treasury (1) indicate the level of use of Caribbean Basin tax havens to evade or avoid Federal taxes, and the effect on Federal revenues of such use; (2) provide available information on any relationship between such use and other (i.e. non-tax) criminal use, including drug trafficking; and (3) describe current anti-tax haven enforcement activities of the Treasury Department.

B. Level of use of Caribbean Basin tax haven countries and effect on Federal revenues

Chapter III provides information on banking, investment and income flows, and currency flows. This information provides some indication of the level of use of tax havens for the kinds of activities measured. However, it is not possible at this level of aggregation to separate tax haven transactions designed to avoid or evade U.S. taxes from transactions which have no tax effect.

One of the primary characteristics of many tax havens is a disproportionately large banking sector. One measure of the concentration of foreign financial activity is the ratio of foreign asset holdings of deposit banks to foreign merchandise trade. In 1982, the foreign assets of banks in Bermuda, the Cayman Islands, and Panama were sufficient to finance more than 100 times those countries' merchandise exports and in the Bahamas the ratio was over 36. Developing countries (other than oil producing countries) maintained foreign assets equal to only 1.73 times their merchandise exports. Converting those ratios into dollar figures implies that the Bahamas, the Cayman Islands, and Panama held at least $300 billion of foreign assets in excess of their foreign trade requirements in 1982.

The level of offshore banking in the Caribbean Basin countries rose sharply during the period 1978-82. Claims of Caribbean banks (including branches of foreign banks) on non-residents rose from $178 billion in 1978 to $318 billion in 1982. Liabilities to non-residents rose from $178 billion to $315 billion. Similarly, assets of branches of U.S. banks located in the Bahamas, the Cayman Islands, and Panama increased from $97 billion in 1978 to $151 billion in 1982.

Direct investment by U.S. persons in Caribbean Basin tax havens other than the Netherlands Antilles increased from about $14 billion in 1978 to $20 billion in 1982. This increase is comparable to the increase in U.S. direct investment in non-Caribbean Basin countries. However, during the same period, net U.S. borrowing from affiliates in the Netherlands Antilles increased from roughly $1 billion to $16 billion.

The U.S. income of residents of the Netherlands Antilles reported on IRS Form 1042S increased from $191 million in 1978 to $1,400 million in 1981. The U.S. income of residents of other Caribbean Basin countries more than doubled during this period, but these increases were comparable to the world-wide increase of 215% for the 1978-1981 period.

Analysis of Currency Transaction Reports filed by persons with addresses in Caribbean Basin countries reveals a definite imbalance in currency flows for certain countries. Perhaps the most interesting currency flow is the approximately $1 billion deposited by Panamanian residents through Federal Reserve offices (only about $100 million was withdrawn). About half of the total value of these deposits was in $20 or lower denomination bills, which are relatively uncommon in international currency transactions.

Chapter III also discusses the elements needed to construct an estimate of tax revenues lost through the use of Caribbean Basin tax havens. As a consequence of the conceptual as well as practical problems outlined there, no specific revenue estimate is presented in this report.

C. Non-tax criminal use of tax havens

Chapter IV presents several examples of the use of tax havens for non-tax criminal activity. Although these examples do not prove any particular relationship between the existence of tax havens and criminal activity, they do provide a feeling for the kinds of activity fostered by the conditions of bank and commercial secrecy generally associated with tax havens.

D. Current anti-tax haven enforcement activities of the Treasury Department

Chapter IV provides information about the anti-tax haven activities of the Treasury Department and the Internal Revenue Service. This chapter includes discussions of recent legislative initiatives, special audit programs, and a general discussion of tax treaty policy with regard to tax havens.

E. Conclusion

This report is intended primarily to update the material provided in the Gordon report. The data collected and presented in this report show that the use of tax havens, which was already very significant at the time the Gordon report was prepared, has continued to rise sharply. It is very difficult to measure the illegal use of tax havens because of the nature of the transactions and because of the difficulty of obtaining information from most tax havens. Nevertheless, it seems reasonable to assume that a great deal of activity designed to violate the tax and other laws of the United States takes place in the Caribbean Basin tax havens. The examples of recent cases in Chapter IV provide a sampling of the variety of possible illegal uses of havens.

No attempt has been made to suggest solutions to the problem presented by tax havens. Both the Gordon report and the Senate report contain numerous well-reasoned suggestions for attacking the problem. Some of the proposed responses have been incorporated into legislation (including TEFRA and the CBI), others have resulted in changes in procedures and an increased emphasis on curbing tax haven abuses. No single action will solve the problem of tax haven abuse. Nor is it reasonable to expect that addressing the problem in one region will deter the use of tax havens in other parts of the world; on the contrary, it might well encourage shifting from one haven to another. The international scope of the problem may require an internationally coordinated solution. The Treasury Department will continue its efforts to minimize the abuse of tax havens, including consulting with other countries in seeking new ways to reduce their use.

IFA news

SRI LANKA BRANCH

The Sri Lanka Branch organised in collaboration with the Asian Pacific and Investment Research Centre (Singapore) a seminar on "Double tax treaties between developing countries and developed countries with special reference to Sri Lanka" on 18 February 1984 in Colombo.

The seminar was inaugurated by the Hon. Minister of Finance and Planning Mr. Ronnie de Mel and was addressed by the following speakers: Mr. S. Ambalavaner (Chairman IFA Sri Lanka Branch); Prof. J. van Hoorn Jr. (Chief Executive, International Bureau of Fiscal Documentation); Mr. J.A.R. Felix (Deputy Director General – Greater Colombo Economic Commission and Former Commissioner General of Inland revenue) and Mr. N.S.L. Perera (Commissioner of Inland Revenue).

Over 75 participants (consisting of professionals, tax officials, businessmen, and executives) attended the Seminar showing a keen interest in the subject discussed.

THE UNITED NATIONS ECONOMIC COMMISSION FOR AFRICA (ECA)
invites applications from
EXPERTS IN THE FIELD OF TAX ADMINISTRATION
to carry out studies as described below on a consultancy basis.

1. Study on the harmonization of the tax policies of six selected countries of the West-African Subregion.
2. Feasibility study on the development or establishment of subregional or regional tax training facilities and centres in four selected African countries.

Requirements:
- The consultants must have an excellent knowledge of both the English and French languages.
- They must be experienced in matters of tax administration.
- They must be willing to undertake field studies in the countries mentioned for periods of 5/6 and 4 weeks, respectively.
- They must first come to Ethiopia for consultation with ECA.

Remuneration:
- ECA will meet the air fare on economy class basis.
- Consultants will receive a per diem allowance at United Nations' rates.
- A honorarium of US$ 500.00 per week will be paid for 5/6 and 4 weeks, respectively after the mission reports have been submitted to and accepted by ECA.

Applicants are invited to write to

The Director, PAMM Division,
P.O. Box 3001 – Addis Ababa, Ethiopia

for further information and send their curriculum vitae, two personal history forms and a letter in which they declare their willingness to accept the consultancy assignment. Applications should reach ECA not later than 30 September 1984.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1984 issue. See also Erratum (p. 193 of the May 1984 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Belastingblad, tijdschrift voor provinciale, gemeentelijke en waterschapsbelastingen

This is a bi-weekly periodical dealing with provincial and municipal taxes and levied for regional government organizations. Apart from actual information, it includes commentaries on government reports, court decisions and new legislation and deals with questions of readers.

It can be obtained from Kluwer, P.O. Box 23, 7400 GA Deventer, the Netherlands. The subscription price is based on the number of pages received, estimated at 650 pages for 1984, price per page: 0.326 Dfl.

Fiskoloog International – Belgian International Tax Newsletter

The first issue of this monthly newsletter was published on 15 November 1983. In the first half year it dealt with international tax aspects related to Belgium, e.g. new arrangements for foreign executives, double taxation aspects, but also covered developments in other countries, such as Dutch bank secrecy, the Cyprus route for Netherlands employees working temporarily abroad, first Chinese tax treaty, the U.S.A. unitary tax, etc.

It can be obtained from Fiskoloog, Brasschaatssteenweg 200, B-2180 Kalmthout, Belgium. The subscription price for 1984 is 2950 Bfrs.

Fiscaal Uptodate

This is a bi-weekly periodical of which the Chief Editor, Dr. N. Nobel, is a well-known tax adviser in the Netherlands. All kinds of developments in the tax field are dealt with, including information on new legislation, tax relief for single persons, extra allowances of the WIR (the Investment Account Act), which are currently under discussion, special topics of the VAT, the affiliation privilege for Dutch subsidiaries in Hong Kong, more possibilities for compensation of losses, special secret arrangements made by the Ministry of Finance on the American Land Program, and many other subjects.

It can be obtained from: Euroforum, P.O. Box 845, 5600 AV Eindhoven, the Netherlands. The subscription price for 1984 is 620 Dfl.

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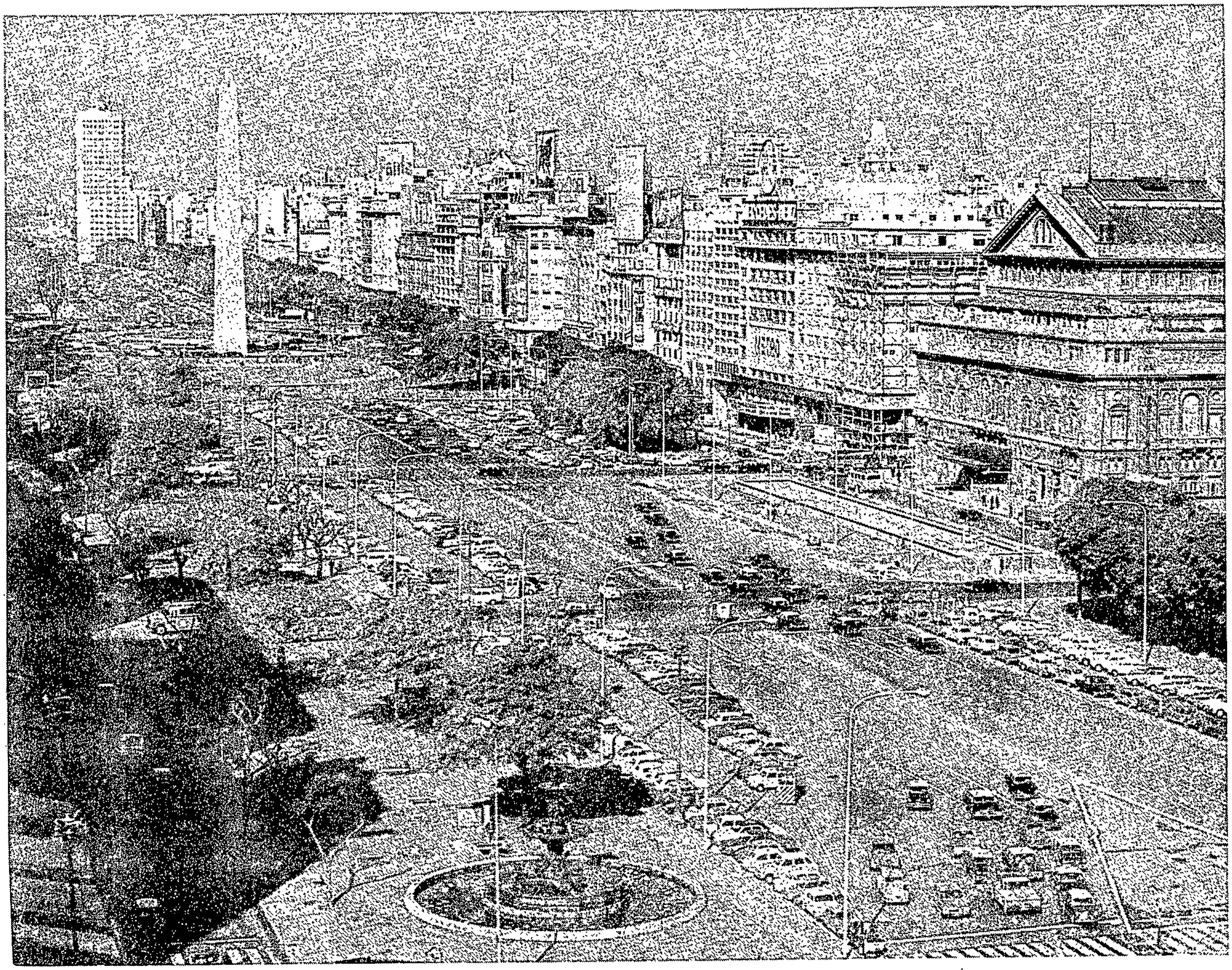

IFA Congress 1984 Buenos Aires

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MAX LAXAN
Président de l'IFA

Congrès 1984 Buenos-Aires

Ce n'est pas, cette année, comme en 1983, une ville chargée d'histoire, au passé prestigieux, qui va accueillir le trente huitième Congrès de notre Association, mais la capitale moderne et dynamique d'un pays jeune, appelé sans nul doute, à travers les aléas de la conjoncture, à un avenir de développement et de progrès. Pour la plupart d'entre nous, cette nation, si éloignée par la distance, nous est proche par la culture, les traditions, le mode de vie. C'est à sa découverte que nous convie le groupement argentin en nous offrant, pendant une semaine, son hospitalité à Buenos-Aires.

Les deux sujets au programme du Congrès de Buenos-Aires sont l'un et l'autre d'un grand intérêt. Le premier est relatif aux obstacles fiscaux susceptibles d'affecter les mouvements de capitaux entre une société mère et ses filiales étrangères. Ce thème est d'importance si l'on veut bien considérer que le développement économique international dépend dans une large mesure du flux de capitaux qui soutiennent l'investissement, qu'ils interviennent entre pays développés ou encore et surtout entre pays développés et pays en voie de développement. Contrairement au premier sujet, qui a été examiné sous des angles et des éclairages divers à maintes reprises par notre Association, le second n'a pas encore fait l'objet d'études de notre part. Il s'agit des prélèvements sociaux, considérés en tant qu'élément de la charge fiscale pesant sur les entreprises engagées dans les activités internationales. Le caractère très spécifique de ces contributions, la variété des prestations qu'elles financent, la simplicité de leur assiette, essentiellement établie sur les salaires versés, n'avaient pas conduit jusqu'à présent l'I.F.A. à éclairer leur mécanisme et à étudier leurs répercussions. En les reconnaissant comme parties intégrantes de la charge fiscale pesant sur les activités économiques et en abordant le sujet sous l'angle qui nous est familier de la concurrence internationale, le second thème proposé à nos réflexions comble utilement une lacune.

Le recensement des obstacles fiscaux de nature à contrarier les mouvements des capitaux entre une société mère et ses filiales étrangères a été effectué par le Professeur K. VOGEL, rapporteur général, avec l'aide des vingt deux rapporteurs nationaux, de manière rigoureuse et approfondie. Le rapport comporte aussi, et il faut signaler son originalité, des approches doctrinales intéressantes, même lorsqu'elles n'emportent pas toujours la conviction. Ainsi l'équivalence globale entre l'imposition établie par un Etat et les prestations qu'il fournit n'ont qu'une valeur très relative s'agissant d'un impôt particulier, comme l'impôt sur les sociétés. Même si l'on écarte les réductions de taux de nature à attirer les investissements, il reste que la fixation du niveau de la charge fiscale obéit à des préoccupations politiques et sociales étrangères à la notion de contrepartie.

En vue de mieux cerner un sujet particulièrement vaste, le rapporteur général a exclu de son étude les effets des doubles impositions juridiques qui peuvent subsister en l'absence de conventions internationales ou malgré celles-ci ainsi que les mesures prises par les Etats en vue de décourager la circulation des investissements ou encore les mesures restrictives qui frappent également résidents et non résidents. En définitive, le propos de l'auteur a été de mettre en lumière les dispositions dont l'effet indirect et, a priori, non recherché par le législateur, est de ne pas assurer une égalité de traitement fiscal selon que l'investissement est effectué sur le territoire national ou à l'étranger, en ce qui concerne le pays exportateur de capitaux, et selon l'origine, nationale ou étrangère, des investissements, en ce qui concerne le pays importateur de capitaux.

La grande diversité des législations fiscales applicables à l'imposition des bénéfices et à la distribution des dividendes tant dans l'Etat de la source que dans l'Etat de la résidence que l'étude met pleinement en lumière sont à l'origine de maints obstacles à la circulation des capitaux selon leur plus grande efficacité économique, que les conventions tendant à éviter la double imposition ne parviennent pas à réduire dans une mesure suffisante. Ainsi les pays d'accueil, qui cherchent à favoriser les investissements sur leur sol, par le jeu du taux de l'impôt sur les sociétés, imposent parfois lourdement les dividendes en découlant, par une retenue à la source élevée sur leur montant brut, ou encore assimilent de façon très extensive à des distributions de bénéfices certains transferts opérés par la filiale à destination de la mère étrangère. Inversement les pays exportateurs de capitaux, en pratiquant l'imposition selon le bénéfice mondial ou en privant les actionnaires de toute imputation tenant compte de l'impôt acquitté au niveau de la filiale, aggravent la charge fiscale pesant sur les revenus en provenance de l'exploitation étrangère de la société-mère résidente.

Ces exemples, pris parmi d'autres dans le relevé très documenté et très complet effectué par le Professeur K. VOGEL, montrent que les Etats, qu'ils soient importateurs ou exportateurs de capitaux, devraient examiner l'ensemble de leur réglementation fiscale pour en retrancher ce qui contrarie de développement des investissements internationaux entre une société-mère et ses filiales et dont la sauvegarde de leurs légitimes intérêts n'exige pas le maintien.

Le développement de la Sécurité sociale, au sens le plus large du terme, a constitué un élément déterminant de la politique d'amélioration des conditions de vie qui, dans tous les Etats, a marqué les dernières décennies. Le degré de plus en plus élevé de protection recherché en faveur des individus et des familles a gonflé très fortement le volume des prélèvements affectés au service des diverses prestations si bien que le montant du budget social, géré par des organismes spécialisés, peut, à l'extrême, se comparer, par son importance, à celui de l'Etat lui-même. Ce phénomène est bien mis en lumière dans l'excellent rapport général que J. MACON et E. REIG ont soumis à nos réflexions, à partir de quinze rapports nationaux qui décrivent dans le détail le contenu de régimes qui, s'ils tendent à la même finalité, présentent, pour des raisons historiques ou sociologiques, de notables différences.

L'approche commune de tous ces régimes, ou de la plupart d'entre eux, a été de réaliser une mutualisation des risques, qu'il s'agisse de la maladie, des charges familiales, du chômage ou de la retraite. Certes cette mutualisation avait pu se manifester à travers un système volontaire d'assurances. Mais elle ne pouvait trouver une expression parfaite que dans un système obligatoire à base de cotisations qui, par bien des traits, peuvent être assimilés à des impôts. La fiscalisation devient totale lorsque les dépenses, ou une partie d'entre elles, sont prises en charge par la collectivité et financées par des impôts spéciaux, voire par le budget général.

L'essentiel des ressources alimentant les dépenses de Sécurité sociale est encore le plus souvent un prélèvement direct sur les salaires, partie à la charge de l'employeur, partie à la charge du salarié. Ce prélèvement, qui peut représenter un pourcentage élevé du salaire, est au centre de notre sujet, tel qu'il a été défini comme un élément de la charge fiscale pesant sur les entreprises engagées dans des activités internationales.

Le rapport général examine tout d'abord, et principalement, les risques de double imposition qui pourront se présenter, au détriment du salarié ou de l'entreprise, par suite du conflit de deux réglementations, celle du lieu où la prestation de service est effectuée et celle de la résidence de l'employeur ou du salarié.

Les règles internationales communément admises et dont les règlements de la Communauté Economique Européenne des 14 juin 1971 et 21 mars 1972 représentent l'expression la plus achevée, reconnaissent le principe de la territorialité, sauf le cas de détachement provisoire du salarié pour une courte durée; d'autre part, les périodes d'emploi dans le ressort de diverses juridictions sont totalisées en vue d'allouer au salarié, pour le calcul de sa retraite, le plein bénéfice des prestations auxquelles il a droit. A de rares exceptions près, le principe de territorialité est également appliqué dans les législations des pays examinés. Il s'ensuit que les conflits de juridiction portent surtout sur les conditions et les modalités d'exonération des travailleurs temporaires. Mais ces difficultés ont été le plus souvent résolues par des traités bilatéraux ou multilatéraux, de sorte que les cas de double imposition semblent être peu fréquents.

La seconde partie du rapport général est consacrée à l'analyse économique des effets des prélèvements sociaux sur la capacité concurrentielle des entreprises. Elle comporte d'intéressantes remarques doctrinales relatives aux conséquences des prélèvements sociaux sur l'investissement et sur l'emploi ainsi que sur les incidences respectives des taxes sur les salaires et des taxes à la consommation. Elle passe enfin en revue les recherches effectuées dans les différents pays en vue de réduire les charges pesant sur les entreprises exportatrices en général, ou sur certaines d'entre elles, pour lesquelles le coût de la main d'oeuvre est un facteur prépondérant du prix de revient.

On est tenté de conclure de la lecture du rapport très documenté et très pertinent établi par J. MACON et E. REIG qu'en définitive, les prélèvements sociaux, dans la mesure où ils sont proportionnels aux salaires versés et sont directement affectés au service des prestations, représentent en fait des salaires différés ou redistribués. Dès lors leur atténuation, en faveur des activités à l'exportation, apparaît bien contraire aux règles dégagées par la doctrine internationale et retenues par des organismes comme l'O.C.D.E. ou la C.E.E. La seule démarche possible consiste par suite à fiscaliser plus complètement une partie des prélèvements pour les tranformer en taxes à la consommation. Mais cette orientation, dans laquelle plusieurs pays se sont engagés, trouve rapidement ses limites en raison de la part déjà très importante de ces taxes dans la structure fiscale des pays concernés et de l'effet inflationniste direct que comporte leur majoration.

Il faut rendre hommage aux rapporteurs généraux des deux sujets pour avoir si heureusement opéré la synthèse des travaux détaillés effectués par leur collègues nationaux et fourni à nos réflexions la matière de débats de qualité.

Le programme du Congrès sera complété, cette année, par la tenue de trois séminaires, qui tous méritent l'attention. Le premier concerne les ajustements fiscaux dans les pays dont le taux d'inflation est élevé. L'inflation, dès qu'elle dépasse certaines limites, appelle en effet des correctifs particuliers si l'on veut éviter les graves distorsions qu'elle engendre dans la répartition de la charge fiscale entre les divers agents économiques. Le recensement des dispositifs mis en place et le jugement porté sur leur efficacité seront certainement appréciés de nombreux participants. Le second thème de séminaire est beaucoup plus classique, puisqu'il est relatif au statut juridique et fiscal des investissements étrangers dans le pays hôte. Le dernier séminaire enfin, concernant la répartition du pouvoir d'imposition dans le système fédéral argentin, portera l'éclairage dans un domaine du droit public resté jusqu'à présent étranger aux travaux de notre Association.

Il me reste, pour conclure, à souhaiter que nous nous retrouvions très nombreux en septembre et à formuler des voeux très chaleureux pour la pleine réussite, sur tous les plans, du Congrès de Buenos-Aires.

Congress Buenos Aires 1984

This year it will not be – as in 1983 – a city with a rich history and a proud past which receives the 38th Congress of our Association, but the modern and dynamic capital city of a young country which is, notwithstanding the hazards of the world economy, undoubtedly destined for a future of development and progress. For the majority of our members this nation, although very remote in distance, is close through its culture, its traditions and its way of life. The Argentine branch now invites us to discover this country by offering us, during one week, its hospitality in Buenos Aires.

The two subjects on the Congress programme are both of great interest. The first deals with the tax obstacles which may affect the movement of capital between a parent company and its foreign subsidiaries. This subject is important if one considers that international economic development depends to a large extent on the flow of capital which feeds investment, whether it takes place between developed countries or, especially, between developed and developing countries.

In contrast with the first subject, which has been examined by our Association many times and from various angles and points of view, the second subject is a newcomer in our deliberations. It concerns social contributions as an element of the fiscal charge imposed on enterprises engaged in international activities. The very specific nature of these contributions, the variety of social services which they finance and the simplicity of their taxable base – essentially consisting of salaries paid – have up to now not induced the IFA to elucidate their mechanism and to study their repercussions. By recognizing that social contributions are an integral part of the fiscal charge on economic activities, and by approaching this subject from a viewpoint which is familiar to us, i.e. that of international competition, the second subject will very usefully fill a gap.

A critical study of the tax obstacles which may hamper international movements of capital between a parent company and its foreign subsidiaries has been undertaken by Professor K. Vogel, general reporter, with the assistance of twenty-two national reporters, in a rigorous and thorough manner.

This report includes – and one should emphasize its originality – interesting theoretical approaches, although they are perhaps not always quite convincing. Thus the adage of the general parity between the taxes imposed by a State and the services it renders has only a limited value, especially where it concerns a particular tax such as the corporate income tax. Even if one does not take into account any rate reductions granted with a view to attracting investment, it can still be stated that establishment of the level of the tax charge is governed by political and social motives which are alien to the concept of a quid pro quo.

In order to delineate an extremely vast subject, the general reporter has refrained from examining the effects of legal double taxation which may occur in the absence of international treaties, or even where treaties exist, the measures taken by States to discourage the flow of investments or, again, any restrictive measures which affect both residents and non-residents. In sum, the purpose of the author was to shed light on those provisions which have an indirect effect which has not a priori been sought by the legislator and which result in inequality of tax treatment between domestic and foreign investment with respect to capital-exporting countries and between the origin (domestic or foreign) of investments with respect to capital-importing countries.

The great diversity of legislation applicable to the taxation of income and the distribution of dividends in the source State as well as in the State of residence is – as the study makes it abundantly clear – at the root of the many obstacles to the flow of capital and frustrates their best possible economic efficiency; these obstacles are not sufficiently removed by double tax treaties. Thus the recipient countries which seek to favor investment on their territory through low rates of corporate income tax often tax dividends heavily by imposing a high withholding tax on their gross amount, or define in a very extensive manner profit distributions so that certain transfers from the subsidiary to its foreign parent company are deemed to be dividends. On the other hand, capital-exporting countries which impose their taxes on world-wide income, or which deny shareholders any credit for tax levied at the subsidiary level, increase the tax burden on income derived by resident parent companies from their foreign activities.

These examples, chosen among others in the very well documented and complete survey written by Professor K. Vogel, show that States, whether they be importers or exporters of capital, should scrutinize their entire tax legislation in order to eliminate those provisions which are an obstacle to the development of international investments between a parent company and its subsidiaries, the upholding of which is not required by the legitimate interests of States themselves.

The development of social security, in its broadest sense, constitutes a decisive element of the social policies which have marked the last decades in all countries. The ever higher level of protection sought for by individuals and families has very much inflated the amounts of the levies used to finance the various services rendered so that the level of the social budget, which is usually managed by specialized organizations, may in extreme cases approach that of the State itself. This phenomenon has been very well highlighted in the excellent general report which J. Macon and E. Reig submitted to our scrutiny and which is based on fifteen national reports describing in detail the provisions of regimes which, although they tend in the same direction, present, as a result of historical and social peculiarities, marked differences.

The common approach of all those systems, or at least of the majority of them, has been the spreading of risks, whether concerning illness, familial charges, unemployment or retirement. Indeed, such spreading of risks could also have manifested itself through a voluntary insurance system. However, it could find its perfect expression in a mandatory system based on contributions, which, because of many of their characteristics, can be regarded as taxes. This "fiscalization" of the social security system becomes complete when the expenses, or part of them, are taken over by the community and are financed by special taxes, or even through the general budget.

The main source of revenue used to finance the expenses of the social security system is still mostly a direct levy on salaries, of which part is imposed on the employer and part on the employee. This levy, which may represent a high percentage of the salary, is the central theme of our subject, as it has been defined as an element of the fiscal charge imposed on enterprises which engage in international activities. The general report examines, first and foremost, the risk of double imposition which may present itself to the detriment of the employee or the enterprise and which may be caused by the conflict between two systems of regulation, i.e. the system existing in the place where the service has been rendered and the system existing in the place where the employee or the enterprise is resident.

The international rules which are generally accepted – and of which the regulations of the European Economic Community of 14 June 1971 and 21 March 1972 are the most sophisticated expression – recognize the principle of territoriality, except in the case of an employee who is provisionally transferred abroad for a short period of time. On the other hand, the amount of time spent in employment in the various jurisdictions is aggregated in order to give the employee, for the computation of his pension, the full benefit of the allowance to which he is entitled. With only rare exceptions is the principle of territoriality also applied in the countries studied. Consequently, possible jurisdictional conflicts concern above all the conditions and modalities under which temporary workers are exempted. However, these difficulties have in most cases been resolved through bilateral and multilateral treaties so that cases of double taxation do not seem to be very frequent.

The second part of the general report is dedicated to an economic analysis of the effects of social security contributions on the ability of enterprises to compete. It contains interesting theoretical remarks on the consequences of the imposition of social security contributions on investment and employment as well as on the incidence of payroll taxes and taxes on consumption. Finally, it gives an overview of the research carried out in the various countries with a view to the reduction of the charge imposed on exporting enterprises in general, or on certain of them, for which labor cost is a predominant cost-price factor.

One is tempted to conclude from the reading of the very detailed and pertinent report by J. Macon and E. Reig that social security contributions, in so far as they are proportional to the salaries paid and are directly used to finance the services, ultimately represent in fact deferred or redistributed salary. Consequently, their mitigation in favor of export activities appears to be contrary to rules established under prevailing international theory and which have been adopted by organizations like the OECD or the EEC. The only way to proceed in this matter is, therefore, to incorporate to a larger extent part of these contributions in the tax system and change them into consumption taxes. However, this shift in the direction of consumption taxes – which a number of countries have effected – soon finds its limits because such taxes already play a very important role in the tax structure of the countries concerned and because of the direct inflationary effect which is inherent in their increase.

We must pay tribute to the general reporters of the two subjects for having so successfully found a synthesis for the detailed work performed by their national colleagues and to have supplied us with the material for high level discussions.

The programme of the Congress will this year be completed by three seminars, all of which merit the full attention of the delegates. The first concerns the adjustments in the tax systems of those countries which have high rates of inflation. When inflation exceeds certain limits, particular correction measures must be taken if one wishes to prevent certain serious distortions caused in the distribution of tax burden between various economic subjects. The overview of the existing provisions and the evaluation of their effectiveness will undoubtedly be appreciated by many delegates. The second theme to be discussed is a much more classical topic, since it concerns the legal and tax status of foreign investment in the host country. Finally, the last seminar – concerning the allocation of the power to impose tax in the federal Argentine system – will shed light on a field of public law which is so far from the work of our Association.

It only remains for me, in conclusion, to hope that we will meet each other in great numbers in September and to express my warmest wishes for the complete success, in every respect, of the Congress of Buenos Aires.

Las Perspectivas de las Políticas Económica y Fiscal de la Argentina

Por Dr. Bernardo Grinspun
Ministro de Economía de la Nación

La definición de una política fiscal que contribuya a la estabilización del sector interno y el ordenamiento del sector externo en el marco de un crecimiento de la actividad económica resulta un instrumento clave para la política que ha puesto en vigencia el nuevo gobierno constitucional en la República Argentina.

El enfoque Keynesiano tradicional ha puesto énfasis en el tamaño del gasto público para actuar como factor de impulso de la demanda efectiva, argumento que ha tenido relativa validez en las primeras décadas de la posguerra en economías con alta capacidad ociosa. En años recientes los mismo defensores de la economía Keynesiana han destacado que no es el quantum del gasto el dato relevante sino más bien la distribución del mismo, ya que la experiencia fue demostrando que el efecto de una política fiscal expansiva (o por oposición contractiva) no es idéntico desde el punto de vista macroeconómico según cuáles fueran las áreas de aplicación.

La observación más común se refiere a las filtraciones directas a través de las importaciones que se verifican en algunos rubros del gasto, particularmente en aquellos de tecnología compleja que no suelen proveer las industrias locales en las economías en desarrollo. En ese aspecto el gasto en defensa para equipamiento bélico muestra algunos ejemplos claros al respecto. De hecho la filtración directa por importaciones no agota el problema de la distribución del gasto desde el punto de vista de las repercusiones sobre la demanda efectiva, ya que existen en cada coyuntura segmentos de la actividad en donde la respuesta de la oferta resulta más elástica en el corto plazo, permitiendo una minimización de eventuales efectos inflacionarios del crecimiento del gasto.

Pero el otro elemento clave a tener en cuenta, y creo ello fue señalado por los primeros seguidores de Keynes, como Kaldor, es el impacto sobre la eficacia marginal del capital privado a mediano plazo del gasto público. Una adjudicación de los recursos en proyectos de alta tasa de retorno mejorará la eficacia general de la economía, seguramente mucho más que una simple política de "cavar pozos y volverlos a tapar".

Esta mejor administración de los recursos escasos es tanto más necesaria cuando el segundo dato fiscal a tener en cuenta en la economía argentina de hoy es que en el marco de una estabilización del sector externo existe una limitada cantidad de fondos prestables, lo que hace necesario reducir la participación del sector público como única alternativa para dar espacio al crecimiento de la actividad privada.

Si bien en este breve comentario no hemos querido historiar el pasado reciente de la economía argentina, no podemos obviar datos fundamentales que caracterizan la difícil situación encontrada a fines del año pasado. Una inflación creciente que si bien resultó estadísticamente del 430% anual, amenazaba con trepar a un 2300% anual, ya que se estaba frente a un crecimiento del 30% mensual en los precios al consumidor. Esta inflación se manifiesta en el marco de una economía estancada (muy bajo crecimiento del PBI), fuertemente endeudada con el exterior – con un stock de obligaciones en divisas de los sectores público y privado que superaba los US$

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1957–1958 Asesor Económico Financiero del Ministerio de Hacienda, Agricultura y Obras Públicas de la Provincia de Tucumán.
1957 Delegado observador a la Conferencia Económica Internacional Americana de la Organización de Estados Americanos.
1958–1962 Asesor Financiero, H. Senado de la Provincia de Buenos Aires.
1960 Secretario Técnico de la Comisión Investigadora del Banco de la Provincia de Buenos Aires.
1963–1966 Secretario Ejecutivo del Consejo Nacional de Desarrollo; Director del Banco Central de la República Argentina; Secretario del Gabinete Económico-Social.
1964 Jefe de la Delegación Argentina a la Reunión de Expertos Gubernamentales de América Latina en Política Comercial, Brasilia; Presidente del Comité I "Productos Básicos"; Jefe de la Delegación Argentina a la II Reunión de la Comisión Preparatoria de la Conferencia de las Naciones Unidas sobre Comercio y Desarrollo, Nueva York; Delegado Argentino a la Reunión de la Comisión Especial de Coordinación Latinoamericana, Alta Gracia; Delegado Argentino a la I Conferencia de las Naciones Unidas sobre Comercio y Desarrollo: Presidente del Comité de "Productos Básicos", Ginebra; Jefe de la Delegación Argentina a la III Reunión del Consejo Interamericano Económico y Social a Nivel de Expertos, Lima.
1965 Misión refinanciadora de la Deuda Externa Argentina. (E.E.U.U., Japón y Europa); Jefe de la Delegación Argentina a la Reunión Extraordinaria de la Asociación Latinoamericana de Libre Comercio. Presidente de la Reunión – Montevideo; Embajador y Ministro Plenipotenciario a la Reunión Extraordinaria de Cancilleres de la Organización de Estados Americanos – Río de Janeiro; Jefe de la Delegación Argentina a la VI Reunión de la Comisión Económica para América Latina – Santiago de Chile; Delegado Argentino a la Reunión de Bancos Centrales – México; Gobernador Alterno del Fondo Monetario Internacional – Washington; Delegado Argentino a la Reunión del Comité Interamericano de la Alianza para el Progreso – Río de Janeiro.

1966 Presidente de la IV Reunión del Consejo Interamericano Económico y Social a Nivel de Expertos – Buenos Aires; Secretario de Estado de Comercio.
1967–1969 Asesor Regional de las Naciones Unidas en Problemas Institucionales y de Formulación de Política Comercial.
1967–1969 Director del Curso Regional de Política Comercial, organizado por las Naciones Unidas – Santiago de Chile; Profesor del Curso de Política Comercial, organizado por la CEPAL – San Salvador.
1969–1975 Profesor del Curso sobre Comercialización, organizado por el Centro Interamericano de Comercialización Nacional e Internacional – Río de Janeiro; Director del Curso de Política Comercial organizado por el Colegio de Graduados en Ciencias Económicas de Buenos Aires y la CEPAL.
1970 Consultor Especial de la Organización de Estados Americanos en Política Comercial.
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1973 Profesor del Curso sobre Política de Comercio Exterior. Organización de Estados Americanos y Gobierno de la República Dominicana – Santo Domingo.
1974 Profesor del Curso de Política de Comercio Exterior organizado por la Secretaría de la Organización de Estados Americanos y el Gobierno de Bolivia – La Paz; Director (por concurso) del Curso de Especialización en Comercio Exterior organizado por el Colegio de Graduados en Ciencias Económicas por contrato con el Ministerio de Economía y la Secretaría de Estado de Relaciones Económicas y Comerciales Internacionales del Gobierno Argentino – Buenos Aires.

Actuación Universitaria:
1948–1949 Miembro de la Comisión Directiva del Centro de Estudiantes de Ciencias Económicas – Buenos Aires; Secretario General de la Federación Universitaria de Buenos Aires.
1949–1951 Miembro de la Mesa Directiva de la Federación Universitaria Argentina.
1956–1957 Miembro de la Comisión de Docencia de la Junta Consultiva de la Facultad de Ciencias Económicas – Buenos Aires.
1960 Miembro del Jurado para el Concurso de Profesores de Historia Económica Social de la Facultad de Ciencias Económicas. Universidad de Buenos Aires.
1960–1961 Secretario del Departamento de Graduados de la Facultad de Ciencias Económicas. Universidad de Buenos Aires.
1962–1963 Miembro de la Comisión de Intercambio de Profesores con la Universidad de Colombia y la Facultad de Ciencias Económicas de la Universidad de Buenos Aires.

Actuación Política:
1951 Delegado de la Provincia de Buenos Aires al Congreso Nacional de la Juventud de la U.C.R. – Córdoba.
1953 Delegado de Avellaneda al X Congreso de la Juventud Radical de la Provincia de Buenos Aires – Tres Arroyos.
1954–1955 Delegado de la Organización de la Juventud al Comité de la Provincia de Buenos Aires de la U.C.R.
1958–1962 Asesor Económico Financiero del Bloque de Senadores de la U.C.R. del Pueblo de la Provincia de Buenos Aires.
1960 Miembro del Congreso Municipal organizado por el Comité de la Provincia de la U.C.R. del Pueblo – Mar del Plata.
1961 Delegado del Comité de la Provincia de Buenos Aires, al Congreso Agrario organizado por la U.C.R. del Pueblo de Córdoba.
1961–1965 Miembro de la Honorable Convención Nacional de la U.C.R. del Pueblo.
1972–1976 Miembro de la Honorable Convención Nacional de la Unión Cívica Radical.
1983 Secretario de la Honorable Convención Nacional de la Unión Cívica Radical.

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43 mil millones –, y con un absoluto descontrol monetario y fiscal. Los recursos monetarios totales apenas superaban a fin de año un 12% de producto, con un déficit del sector público superior a un equivalente anual del 14% de P.B.I.

En este contexto resultaba más que evidente la imposibilidad de financiar tamaño desequilibrio en el sistema interno, fenómeno que unido a la incapacidad para tomar crédito en el exterior, significa la necesidad de emitir dinero primario para financiar al fisco en proporciones explosivas de no recortarse el déficit.

Sin achicamiento del déficit no habrá espacio para ninguna recuperación de la actividad privada que no obtendrá fondos, ya que éstos son absorbidos en más de dos terceras partes por el sector público, a pesar de la expansión constante de la oferta de dinero.

Si bien el programa fiscal significa desde un primer momento recuperar la capacidad de recaudación de impuestos y la mejora de los ingresos de las empresas públicas a través del aumento real en los precios de los combustibles y en las tarifas de los servicios, el ajuste no puede ni debe operar exclusivamente del lado de los recursos.

De allí entonces la importancia de redistribuir las partidas de gastos, para procurar su disminución global en un contexto de reasignación de recursos para su optimización económica y social. Es así que las áreas de educación, salud y vivienda se consideran prioritarias, mientras que incluyendo este último rubro (construcción de nuevos hogares) el conjunto de la inversión pública se incrementa, a la vez que se establecen nuevas metas en función de la tasa de retorno prevista para los distintos proyectos.

Esta última tarea exige un manifiesto reordenamiento de la técnica presupuestaria, su puesta al día y más todavía, su adecuación a una nueva estructura democrática de gobierno, en la que las decisiones deben ser compartidas por las distintas áreas del sector público en un marco de participación y responsabilidad por los resultados. De este modo, siendo finalmente el Congreso de la Nación el que aprueba el presupuesto de gastos y cálculo de recursos, se llega a una aceptación de la política adoptada, con una consecuencia favorable sobre la eficacia de los mecanismos de ejecución y control presupuestario.

Para las economías en desarrollo el presupuesto es un instrumento vital en la ejecución de una política, por lo que la eficacia del mismo depende tanto de las previsiones efectuadas como de la efectiva aplicación práctica del gasto en cada repartición.

El Poder Ejecutivo ha previsto una manifiesta reducción del déficit fiscal en el ejercicio 1984, que promediaría menos del 9% de P.B.I. en el año, frente a un 11,2% en 1983. De todos modos, como ya fuera señalado, la situación de arrastre era más grave puesto que el último trimestre señalaba un absoluto desborde fiscal.

Ya en el primer trimestre de 1984 se obtuvieron buenos e interesantes resultados, con un fuerte recorte de gastos en términos reales y un déficit inferior al 10% de P.B.I.

Al desequilibrio propiamente dicho cabe sumar otro del Banco Central, producto de pérdidas netas en las operaciones de intermediación que desempeña el organismo pagando intereses por el encaje de los depósitos y percibiendo aquellos del redescuento. La pérdida se origina – fundamentalmente – en el mayor monto de depósitos a interés respecto del crédito, fenómeno que se refleja en una alta tasa de efectivo mínimo. Con la reducción del déficit fiscal será posible ampliar el crédito al sector privado y para ello podrá instrumentarse una rebaja del encaje, lo cual irá reduciendo hasta su desaparición el otro déficit que se origina en las operaciones del Banco Central.

El déficit global previsto para el ejercicio 1984 es compatible con una fuerte reducción de la tasa de inflación, que esperamos sea de sólo un dígito mensual en el último trimestre. A su vez, con menores tasas de aumento de precios y tasas de interés reales mayores que cero será posible aumentar la demanda de dinero y mejorar la liquidez de la economía, ampliando además el crédito. Ello es la base para el logro del objetivo de crecimiento general de la actividad.

La reducción del déficit fiscal si bien como se ha destacado significaría un esfuerzo en el recorte de gastos, implica también una efectiva reforma del sistema tributario, cuyo análisis profundo escapa a este comentario genérico sobre el programa económico.

Es importante, con todo, destacar dos características generales de la política, la primera el énfasis en una mayor progresividad de la carga tributaria a través de reformas de fondo a los gravámenes a las ganancias, a los capitales y al patrimonio neto. En este aspecto debe señalarse que si bien este tipo de gravámenes suelen afectar las decisiones de inversión del sector privado, en el caso argentino la legislación – que será adecuada a las nuevas necesidades del país – prevé importantes beneficios fiscales en el régimen de promoción industrial, con lo cual los nuevos proyectos gozan de importantes exenciones cuando existe un aporte apreciable de capital de riesgo. Estos beneficios impositivos se complementan con facilidades crediticias.

El agro, por su parte, si bien realiza un importante aporte impositivo ya que a los gravámenes habituales agrega el pago de derechos de exportación en el caso de bienes tradicionales – granos, subproductos, aceites y carne –, recibe desde ahora un especial aliciente a través de la eliminación de los aranceles de importación de fertilizantes. Están en estudio diversas medidas de regulación de la comercialización con apoyo crediticio para los productores, para asegurar a éstos que en términos de cantidad física de grano producido el fertilizante tendrá un valor constante. Con ello la producción primaria argentina entrará en un nuevo escalón tecnológico, ampliando aceleradamente los volúmenes de las cosechas, mientras ello permitirá crear un importante mercado interno para los agroquímicos. De este modo será rentable en un plazo de pocos años la elaboración de fertilizantes en el país en gran escala, a partir de gas natural, combustible del que el país dispone de abundantes reservas.

La segunda característica que deseamos destacar en la política tributaria es el énfasis puesto en el reordenamiento general del sistema. En primer lugar, se han recreado las instituciones y los mecanismos dirigidos a la normalización del cumplimiento de las obligaciones de los contribuyentes, para el logro de una necesaria reducción de la evasión fiscal, a partir de una generosa moratoria para el pago de deudas vencidas.

En segundo lugar, han comenzado a restablecerse algunos gravámenes sobre salarios que fueran suprimidos años atrás y que si bien no son las más adecuados desde el punto de vista de la teoría contributiva, son los únicos capaces de permitir el saneamiento del sistema de seguridad social y de construcción de viviendas económicas. En efecto, los aportes "patronales" sobre salarios para jubilaciones y para el Fondo Nacional de la Vivienda, permitirán el autofinanciamiento de los organismos que administran estos sistemas y que por no contar con recursos propios en la medida adecuada retiran fondos de la Tesorería, la que a su vez no cuenta con medios ni instrumentos adecuados para el control de esos gastos.

El autofinanciamiento en estos casos permite a su vez ampliar la disponibilidad de recursos tributarios en el sistema de coparticipación federal, que distribuye esos ingresos entre el gobierno central y las provincias. Precisamente, la caída real de los ingresos de la coparticipación obliga a los gobiernos provinciales a solicitar crecientes aportes directos del Tesoro, lo que significa una verdadera distorsión del sistema de distribución de los recursos.

La ampliación de los ingresos de la coparticipación permitirá el tesoro reservar los aportes directos de fondos para casos particulares – y no ya generales – según criterios de ayuda razonables, relacionados además con las carencias de regiones más pobres y con los esfuerzos que efectivamente realicen los gobiernos locales por mejorar sus finanzas, para premiar y apoyar las mejores gestiones.

La tarea de reordenamiento incluye el retorno de las tarifas públicas a valores reales más altos, que permitan la cobertura de los gastos corrientes de las empresas públicas y puedan además contribuir al financiamiento de las inversiones.

Dadas las carencias de recursos en el corto plazo se apeló a una valorización real importante de los combustibles liquidos y dentro de ellos de las naftas, para proporcionar ingresos a la Tesorería, existiendo un margen importante para esa política dada la amplia brecha entre los precios internos y los internacionales.

Si bien se trata de un impuesto al consumo, dada la composición de la demanda de motonaftas no puede considerarse particularmente regresivo este gravamen, que a su vez se justifica desde el punto de vista de la asignación de los recursos. Otros impuestos al consumo, en particular el IVA en alimentos y medicamentos, fueron eliminados.

POLITICA FISCAL Y AJUSTE ECONOMICO

La Argentina ha emprendido la refinanciación de su deuda externa, partiendo del principio de pagar de acuerdo con sus posibilidades en un contexto no recesivo. En este sentido, si bien muchos de los elementos tradicionales del ajuste de la balanza de pagos deben adoptarse por razones estrictamente técnicas, se ha propuesto el logro de esa estabilización con el menor costo social posible e incluso con una moderada reactivación de las actividades internas.

En este aspecto la misma estabilización del sector externo requiere la expansión de las exportaciones y la sustitución de importaciones para la industria nacional, factores ambos de repercusión positiva sobre el crecimiento que será factible en cuanto la coordinación de las políticas monetaria y fiscal permita ampliar los recursos crediticios del sector privado.

La reducción del déficit fiscal y la desaceleración de la creación monetaria permiten prever una reducción de la tasa de inflación, a niveles compatibles con el impuesto inflacionario implícito en el déficit fiscal que debe cubrirse en el orden interno.

Las negociaciones con el Fondo Monetario Internacional, el denominado "Club de París" y la banca comercial tendrán como efecto dejar ordenado el sector externo. La obtención de respetables períodos de gracia y de intereses razonables son una condición básica que la Argentina requiere para pagar puntualmente sus obligaciones.

El país ha mantenido en todo este período su crédito comercial, normalizando las importaciones cuya regulación dispuesta a fin de 1983 ha permitido el fluído abastecimiento de insumos, materiales y repuestos para la producción interna.

Por cuanto en el contexto internacional los programas de ajuste han tenido un impacto recesivo, la política de ingresos desempeña un papel fundamental en la orientación de la actividad económica, controlándose algunos precios rectores como la tasa de interés, la tasa de devaluación, los aumentos del salario nominal y de precios de ciertos productos industriales, amén de las tarifas del sector público. Este ordenamiento de una constelación importante de precios, este vector de precios regulados, no ha sido empleado con fines antiinflacionarios en sentido estricto, sino más bien para impedir que la actividad económica interna se vea alterada (a la baja) por la aplicación de políticas de estabilización.

Desde ya los controles, incluyendo el del mercado cambiario, han sido adoptados como instrumentos transitorios, ya que en el contexto de alta inflación y fuerte déficit del sector externo que heredó el gobierno constitucional el mercado no podía actuar por sí solo como factor de equilibrio convergente. El paulatino retorno a la normalidad, la refinanciación de la deuda externa, la baja del déficit fiscal y la reducción de la inflación permitirán seguramente ir levantando los controles y eliminando restricciones a las operaciones cambiarias. De hecho, en el caso de la política de precios, un primer período en el que muchos valores fueron congelados fue seguido de amplios acuerdos para aumentarlos dentro de las pautas previstas o aún más, en el marco de una creciente flexibilización del régimen vigente.

Si los objetivos de crecimiento con base en la exportación y en la sustitución de importaciones se alcanzan razonablemente en el corto plazo, la economía argentina entrará seguramente en un sendero expansivo en el futuro mediato. En la coyuntura la respuesta del sector agroexportador ha sido muy satisfactoria y muy probablemente en 1984 se tonifiquen las exportaciones, lo que permitirá un saldo comercial superior a los US$ 3.000 millones.

La importante capacidad ociosa vigente en el sector industrial permite apreciar que aún existe espacio para la sustitución económicamente favorable de importaciones, debiendo reconocerse que la ampliación del mercado crediticio es la otra condición requerida para el alcance de un impulso sensible de esa actividad. Con todo, el repunte del consumo interno permite ya alentar buenas perspectivas para el desarrollo sectorial.

La aplicación de las políticas antes descriptas para el desarrollo a mediano plazo de la producción agraria e industrial apoyarán la estabilización del sector externo proveyendo más divisas o ahorrando gastos en importaciones. Este probable impulso de las inversiones debe ser acompañado por la inversión pública, que con la adecuada selección de proyectos deberá ir eliminando los cuellos de botella en infraestructura (v.gr. en materia de puertos) y aumentando la eficacia media de la economía.

El gobierno ha previsto la adecuada planificación de estos programas y para ello ha creado un organismo dedicado a la elaboración del plan de mediano plazo.

El crecimiento de la economía y particularmente de la actividad privada permitirá el cumplimiento de un objetivo hasta ahora crítico, y que es clave para la política fiscal en el futuro, cual es el paulatino traslado de actividades del sector público al privado. Empresas y personal del Estado podrán así dejar de pertenecer a este pero precisamente esta meta será posible sólo en el contexto de un sector privado expansivo.

Ese es el verdadero reaseguro del cumplimiento a mediano plazo del objetivo fiscal de continuar con la reducción del déficit y particularmente del gasto de gobierno. Los recursos, por su parte, podrán afirmarse a través de la consolidación de la capacidad de pago del sector privado que no puede verificarse en una economía empobrecida y asfixiada por falta de liquidez.

El menor déficit fiscal, con un paulatino equilibrio de la "caja", ya que parte de los intereses de préstamos externos en los primeros años serán refinanciados, será la base de la estabilización del sector externo y de los precios.

La propuesta de alcanzar esa meta en un lapso corto y sin recesión es sin duda ambiciosa pero posible. Esta evolución pondrá a prueba la bondad de los supuestos de un nuevo enfoque fiscal, en el que se ha introducido un acercamiento distinto al problema del gasto público.

Al mismo tiempo se incrementa la importancia de reducir la carga fiscal sobre el sector privado, considerando las unidades económicas. En efecto, es posible y deseable que en una primer etapa la carga tributaria aumente sobre la base de percepción de aquellos impuestos eludidos, disminuyendo en cambio el peso fiscal sobre quienes cumplen con sus obligaciones.

Desde ya la base de la riqueza del país, sus recursos naturales en materia alimentaria y energética, asegura un panorama muy positivo para la inversión y por tanto, para el crecimiento. Al mismo tiempo, el desarrollo de nuevas alternativas comerciales, con una paralela y efectiva promoción de la integración latinoamericana, permitirán definir un nuevo modelo de apertura económica. Este estará basado no ya en el viejo esquema agro-exportador de fines del siglo pasado, que intentó reponerse en el pasado reciente (con tan desastrosos resultados), sino por el contrario en la integración de todo el espectro productivo, con un mercado interno sólido y dinámico.

Prospects of the Economic and Fiscal Policies of Argentina*

By Dr. Bernardo Grinspun

The definition of a fiscal policy that would contribute to the stability of the economy's internal sector and to the regulation of the external sector within the framework of a development of economic activity is a key instrument in the economic policy that the new Constitutional Government has put into force in Argentina.

The traditional Keynesian approach has emphasized the size of the public expenditure to stimulate effective demand. This argument has had relative validity during the first decades of the post-war period in economies with their productive capacity highly unoccupied. In recent years, the supporters of the Keynesian economy themselves have remarked that the quantum of the expenditure is not the relevant fact but the distribution thereof, because experience has shown that the effect of an expansive fiscal policy (or, by opposition, a constrictive one) is not identical, from a macroeconomic point of view, in variance, according to the areas of application.

The commonest observation refers to the direct filtration through imports which may occur in some items of expenditure, especially those of complex technology, that domestic industries in less developed countries do not generally supply. In this respect, expenditures for defense in war equipment show some clear examples. In fact, the direct filtration through imports does not end the problem of the distribution of expenditures from the repercussions on the effective demand point of view, because in each situation there are layers of the activity where the reaction of the offer to the demand appears to be more elastic in the short-term, allowing a minimization of eventual inflationary effects of expenditure growth.

But the other key element to take into consideration, and I believe that it was pointed out by the first Keynesian followers like Kaldor, is the effect of public expenditure on the marginal efficiency of private capital at medium term. A granting of the resources to projects with a high rate of return will surely improve the general efficiency of the economy much more than a simple policy of "digging holes and covering them up again".

This improved handling of a scarcity of resources is all the more necessary when the second fiscal fact to take into account in today's Argentine economy is that, within the framework of the external sector stabilization, there is a limited quantity of funds that may be borrowed, which compels the reduction of public sector participation as the sole alternative to give room to the growth of private activity.

Although, in this brief commentary, we did not want to describe the history of the Argentine economy in our recent past, we cannot avoid fundamental data that define the difficult situation that existed at the end of last year: growing inflation that, although statistically an annual 430%, threatened to soar to an annual 2300%, as we were facing a monthly 30% increase in consumer prices. This inflation took place within the framework of a stagnant economy (a very low increase of the GDP) highly indebted to foreign countries – a foreign currency indebtedness of the public and private sectors that exceeded 43 billion dollars – and with total lack of monetary and fiscal control. Total monetary resources just exceeded, at the end of the year, 12% of the product, with a deficit of the public sector exceeding an annual equivalent of 14% of the GDP.

In this context, the impossibility of financing such disequilibrium in the domestic system was more than evident. Such a situation, together with the inability to obtain credit from abroad, would mean issuing currency to finance the Public Treasury in explosive proportions, had the deficit not been curtailed.

Without a reduction of the deficit, no way is paved for any recovery whatsoever of private activity which cannot obtain funds, because more than two thirds thereof are absorbed by the public sector, despite a constant increase in the offer of money.

Though the fiscal programme meant, from the very first, the recovery of the capacity to collect taxes and an increase in the income of public enterprises by means of a genuine increase in fuel prices and in service rates, the adjustment could not, and should not, operate exclusively on the resources side.

Hence, the importance of redistributing expenditures, to achieve a global decrease in a context of reallocating resources to obtain their economic and social optimum. Thus, the areas of education, health and housing were given priority, while including the latter item (building of new homes) increases public investment at the same time that new goals are established according to the rate of return foreseen for the different projects.

This latter task demands an evident reordering of the budgetary technique, bringing it up to date and, even more, adapting it to a new democratic structure of government, in which decisions must be shared by the different areas of the public sector within a framework of participation and responsibility in the results. Thus, the National Congress being the organism that approves the expenditures and the resources budget, we arrive at an acceptance of the policy adopted, with favourable consequences for the efficiency of the performance and budgetary control mechanisms.

For developing economies, the budget is a vital instrument in the fulfilment of a policy, which is why the efficiency thereof depends as much on forecasting the effects as on the effective and practical application of the expenditure in each branch.

The Executive Power has budgeted a significant reduction in the fiscal deficit for 1984, which would reach an average of less than 9% of the GDP in the year, compared with 11.2% in 1983. Nevertheless, as was already pointed out, the inherited situation was more serious since in the last quarter it showed an absolute fiscal overflow.

In the first quarter of 1984 we have already achieved good, interesting results, with a strong curtailment of expenditures in real terms and a deficit lower than 10% of GDP.

To this disequilibrium, we have to add another one, that of the Central Bank, as a result of net losses in the intermediation operations of the organism, paying interest for the reserve requirements and collecting those of the rediscount. Such a loss stems – basically – from the higher amount of interest deposits with respect to credit, a phenomenon reflected in a high rate of minimum cash reserves. With the decrease of the fiscal deficit it will be possible to enlarge the credit to the private sector and thus a decrease of the reserve requirements may be therefore

* *Editors note:* We are very grateful to Minister Grinspun for having submitted both the Spanish and the English versions of his interesting article.

put into effect, reducing until its disappearance the other deficit originating from the Central Bank operations.

The global deficit forseeen for the year 1984 is compatible with a strong reduction of the inflation rate, which we expect to be of only one digit per month in the last quarter. At the same time, with smaller increases in prices and real interest rates higher than zero it will be possible to increase the demand for money and improve liquidity in the economy, enlarging furthermore the credit. This is the basis for achieving the objective of general growth in the activity.

Although, as we have remarked, the reduction of the fiscal deficit would mean an effort to obtain a curtailment in expenditures, it also implies an effective revision of the tax system, whose analysis is not within the scope of this general commentary on the economic programme.

It is important, however, to outline two general characteristics of the tax policy. The first is the emphasis placed on a better distribution of the tax burden by means of substantial amendments to the income, capital and net wealth taxes. In this respect, we have to point out that, although these types of taxes generally affect the investment decisions of the private sector, in our case the legislation – which shall be keyed to the new needs of the country – foresees important fiscal benefits for the regime for industrial promotion. The new projects are thereby entitled to important exemptions when there is a significant contribution of risk capital. These tax benefits are supplemented by credit facilities.

If agriculture, as recognized, is making an important tax contribution through normal taxes and the payment of export duties in the case of traditional export goods such as grain, semi-finished products, oils and meat, it will obtain from now on a special incentive through the elimination of import duties on fertilizers. Several measures of commercialization regulation, with credit aids to producers, are being studied to assure them that, in terms of the volume of grain produced, the fertilizer shall have a constant value. Thus, the basic Argentine production shall enter a new technological era, rapidly increasing harvests. This will allow the creation of an important domestic market for agro-chemicals. Thus, within a few years, large scale domestic production of fertilizers will be profitable since natural gas is a fuel of which our country has ample stock.

The second characteristic which we want to point out in the tax policy is the emphasis on general modification of the system. In the first place, we have brought back the institutions and mechanisms which lead to normalization of the taxpayer's compliance, in order to achieve the necessary decrease in tax evasion, beginning with a generous moratorium allowing payment in installments of debts fallen due.

Furthermore, we have started to bring back some taxes on salaries that had been abolished years back and that, although they are not the most convenient ones from an equity point of view, are the only ones capable of permitting the cleaning up of the Social Security System and of low cost housing. In effect, the "employers'" contributions on salaries for pensions and for the National Home Fund shall allow the self-financing of the organisms that administer these systems; not disposing of their own resources as they should, they withdraw funds from the Treasury, which, at the same time, has neither the means nor the instruments for controlling these expenditures.

In that way, the self-financing of Social Security would permit the availability of tax resources to comply with our co-participation system of federalism which distributes this revenue between the federal government and the provinces. Consequently, the fall in real terms of the co-participation revenue compels the provincial governments to request increasing direct contributions from the Treasury, which means a true distortion of the system of resource distribution.

The increase of the revenues in co-participation will allow the Treasury to address direct contributions of funds towards specific needs and not only to general ones, according to criteria of reasonable assistance which are also related to the needs of the poorer regions and to the efforts that local governments really carry out to improve their self-financing, thus rewarding and backing the best management schemes.

The task of this reorganization includes bringing back public rates to higher real values, which would allow the current expenses of public enterprises to be covered and thus also contribute to the financing of investments.

Due to a short-term lack of resources, the Government is utilizing an increase in real terms in the price of fuel to bring in revenue to the Treasury through the tax on fuel. There was an important margin for this policy due to the ample gap between domestic and international prices.

Though the tax on fuel is a tax on consumption, bearing in mind the composition of the demand of motor fuel this tax cannot be considered as specifically regressive, and, at the same time, can be justified from the point of view of the allotment of resources. Other consumer taxes, especially the Value-Added Tax on food and medical products, were eliminated.

FISCAL POLICY AND ECONOMIC ADJUSTMENT

Argentina has embarked upon the refinancing of its external debt, on the basis of paying according to its possibilities within a non-recessive context. In this sense, although several traditional elements of the balance of payment adjustment must be adopted due to merely technical reasons, the achievement of that stability with the least possible social cost, and also with a moderate reactivation of domestic activities, is the government's purpose.

In this respect, the stability itself of the external sector requires an increase in exports and the substitution of imports by local industry. Both elements have a positive effect on growth which shall be feasible to the extent that the coordination of the monetary and fiscal policies would allow the increase of the credit resources of the private sector.

Reduction of the fiscal deficit and slowing down the issuance of cash money allow one to foresee the reduction of the rate of inflation, at levels in accordance with the inflation tax implicit in the fiscal deficit that has to be faced on the domestic market.

The negotiations with the International Monetary Fund, the so-called Paris Club and commercial banking will lead to the tidying up of the external sector. Obtaining long periods of grace and reasonable interest rates is a basic condition that Argentina requests to pay its obligations on time.

Argentina has maintained, during all this period, its commercial credit, normalizing imports the regulation of which, just in effect at the end of 1983, has allowed a fluid supply of basic elements of production, raw materials and spare parts for domestic production.

As, in an international framework, the adjustment programmes have had a recessive effect, the income policy has a fundamental role in the orientation of economic activity achieved through the control of basics as, for example, interest rates, devaluation rates, salaries, the prices of certain industrial products as well as the rates of the public sector. This putting into order of an important set of prices has been employed as an anti-inflationary measure in a strict sense, but with the aim of deterring the domestic economy from being altered (downwards) by the application of stabilization policies.

Controls, including those of the exchange market, have already been adopted as transitory instruments, since, within a context of high inflation and deficit in the external sector inherited by the constitutional government, the market could not act per se as a factor of converging equilibrium. The gradual return to normality, the refinancing of the external debt, the decrease of the fiscal deficit and the reduction of inflation will, doubtless, allow the removal of controls and the liberalization of exchange operations. In fact, in the case of price policy, a first period in which many prices were frozen was followed by generous agreements to raise them within the guidelines foreseen or within the scope of an increasing flexibility of the regime in force.

If the objectives of growth based on exports and on the substitution of imports are reasonably reached in the short term, the Argentine economy shall surely enter, in the long run, a path of expansion. In this situation, the reaction of the agro-export sector has been very satisfactory and, most probably in 1984, exports shall be increased. This will allow a trade balance over 3,000 million dollars.

The important non-utilized productive capacity that exists in the industrial sector allows us to see that there is still space for the favourable substitution of imports, having to admit that the enlargement of the credit market is the other prerequisite condition for the achievement of a substantial increase in this activity. Nevertheless, the increase of domestic consumption allows us already to foresee favourable prospects for the development of this sector of the economy.

Enforcement of the above described policies for the medium term development of agrarian and industrial production shall contribute to the stability of the external sector, allocating more foreign currency for exports and savings on imports. This probable impulse of investments must be accompanied by a public investment policy that, with an adequate selection of projects, must allow elimination of the bottle-necks in the infrastructure (e.g. regarding ports) and increasing the average efficiency of the economy.

The Government has foreseen the adequate planning of these matters and has created for that purpose an organism devoted to the elaboration of a medium term plan.

The growth of the economy and specifically of private activity shall allow the fulfilment of an objective which until now has been critical, and which is a key to the fiscal policy of the future: the gradual transfer of activities from the public to the private sector. State enterprises and administrative personnel shall cease to belong to the State, but this goal will only be possible within the framework of a flourishing private sector.

This is the true reinsurance of the fulfilment, in the medium term, of the fiscal objective of continuing with the reduction of the deficit and especially with that of government expenditure. Resources, for their part, can be strengthened through the consolidation of the payment capacity of the private sector, which cannot be properly verified in an economy grown poor and asphyxiated due to the lack of liquidity.

The smaller fiscal deficit, with a gradual equilibrium of "cash" (since in the earlier years part of the interest on external loans shall be refinanced), shall be the basis for the stability of the external sector and of prices.

The proposal of attaining this goal in the short term and without recession is, without doubt, ambitious but possible. This evolution shall put to the test the efficiency of the assumptions of a new fiscal thesis, in which a different approach to the problem of public expenditure has been introduced.

At the same time, we have to emphasize the importance of reducing the tax burden on the private sector, considering the economic units. In effect, it is possible and desirable that, in a first stage, the tax burden should increase on the basis of collecting the taxes evaded but decreasing the fiscal burden for those who have fulfilled their obligations.

Of course, the basis of the wealth of the country, its natural resources in food and energy, constitute a very positive panorama for investment, and therefore for growth. At the same time, the development of new commercial alternatives, with a parallel and effective promotion of the Latin American integration, will allow us to define a new model of economic expansion. This model shall be based, not on the old agro-export plan from the end of the last century that people tried to re-establish in the recent past (with such disastrous results) but, on the contrary, on the integration of all the productive spectrum, with a solid and dynamic domestic market.

In the next issue:

THE CHILEAN INCOME TAX REFORM

By Prof. Pedro Massone

The lead article of the Bulletin's October issue is dedicated to an analysis of the recent income tax reform in Chile. This law leaves the First Category Tax intact but introduces a credit against individual income tax. The Second Category Tax as far as levied on independent personal services and the tax on stock corporations are to be gradually eliminated. The progressive rates of the Second Category Tax on employment income and of the individual income tax will be gradually reduced. Chile will not introduce an expenditure tax as earlier planned.

Perspectivas para una Reforma Fiscal en Argentina

Por C.P.N. Norberto A. Bertaina

I. INGRESOS FISCALES

Las condiciones en que se encontraba la economía argentina a fines de 1983 determinan la necesidad de profundos cambios orientados en el sentido que, conforme a los objetivos políticos del gobierno que la ciudadanía eligió, contribuyan a formar el modelo de país que Argentina puede y debe alcanzar.

Estas condiciones pueden sintetizarse en un fuerte déficit fiscal, cercano al 15% del P.B.I., con un antecedente del año 1982 situado en el 14,29%, vale decir en un franco tren de crecimiento; déficit que a diciembre se aproximaba al 20% del P.B.I.

Los objectivos planteados en el Presupuesto de 1983 perseguían lograr un déficit del 8% del P.B.I., meta que no se alcanzó como consecuencia de dos situaciones divergentes: en su concreción los recursos disminuyeron en un 3,31% mientras que las erogaciones crecieron 3,45%.

A su vez, las disminuciones de los recursos efectivamente recaudados con relación a la estimación presupuestaria, responden a una menor recaudación tributaria que representa, en términos del P.B.I. una caída del 2,50% en tributos y de 0,81% en precios y tarifas.

Este caída generalizada puede discriminarse entre los distintos órdenes jurisdiccionales en un 1,82% en el orden nacional, 1,12% en provincias y en el 0,19% en el sistema de seguridad social.

En cuanto a los recursos no tributarios, especialmente constituídos por precios y tarifas de empresas y organismos descentralizados, una caída muy importante se localiza en las provincias que en 1983 sólo cobraron el 70,81% de los montos presupuestados.

Por otra parte en el año 1983, los recursos de jurisdicción nacional sufrieron fuertes caídas en los tributarios sujetos a coparticipación federal, con lo que el efecto nocivo de tal disminución pesó, no sólo en los recursos de la Tesorería General de la Nación, sino también agudizaron el problema de financiamiento de las provincias y la Municipalidad de la Ciudad de Buenos Aires.

Resultó así particularmente serio el problema de financiamiento de las provincias y Municipalidad de la Ciudad de Buenos Aires, que en conjunto vienen experimentando fuertes caídas desde 1980 en sus recursos genuinos, las que debieron ser atendidas con ayuda del Tesoro en proporciones inéditas.

Así, mientras en 1980 los recursos proprios del conjunto representaban el 41,94% del total, en 1983 sólo llegaron al 28,72%. Como contrapartida, el Tesoro debío asistirlas con el 30,28% del total de gastos de todos los gobiernos locales.

Como casos extremos, resulta indicativo señalar que en 1983, los recursos tributarios propios sólo cubrieron el 6,4% y 7,3% de las erogaciones salariales de dos provincias argentinas, en tanto en el otro extremo, la Municipalidad de la Capital Federal obtuvo recursos iguales al 126,4% de los salarios que pagó.

Como consecuencia de tal deterioro en las finanzas provinciales, éstas fueron acumulando libramientos impagos, que determinaron la necesidad de transferir, en diciembre de 1983, la cantidad de 6.008,8 millones de pesos, cifra que resulta ilustrativa al compararla con 951 millones de igual moneda con que el Tesoro Nacional hibía financiado a las provincias en el mes de julio del mismo año.

En los últimos tiempos se citaba como causa determinante de tal deterioro a las modificaciones introducidas en el financiamiento del sistema previsional, al eliminarse en 1980 los aportes patronales, generalizándose el I.V.A. y simultáneamente se modificó el sistema de coparticipación. Esta causa, si bien en alguna medida influyó, no resulta satisfactoria para explicar el insificiente financiamiento de los fiscos locales, lo que queda demostrado cuando analizamos que en 1983, de haberse mantenido el sistema de coparticipación federal vigente hasta el 5 de octubre de 1980, al conjunto de provincias y Municipalidad de Buenos Aires hubiera correspondido la cantidad de 24.991 millones y si bien es cierto la transferencia real fue de 15.696 millones, mediante otros aportes del Tesoro se otorgaron 23.385 millones adicionales más, de donde surge con toda claridad que la recaudación de los tributos coparticipables fue también declinante en el período y la consecuencia de todo ello fue la emisión monetaria que vino a cubrir las necesidades del sector público.

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Analizadas con lo precedente las fallas del financiamiento tenemos que concluir que estaba en crisis, determinada por dos circunstancias: la caída de la actividad económica y las fallas del sistema tributario y de administración de los tributos.

Precisamente desde el punto de vista de los tributos resulta necesario señalar que encontramos un régimen, que por obra de sucesivas reformas que operaron en distintos sentidos, tanto el sector privado como la administración de los tributos, se vieron desconcertados y sin posibilidad de formular proyecciones.

Fundamentalmente el sistema de fiscalización que se basó en el esfuerzo individual y la capacidad de los agentes del organismo administrador, sin una base de datos que apoye la gestión de los inspectores y con metodología de procedimientos que, cuando menos, provocó la reacción negativa de los contribuyentes.

Así, nos encontramos con una compleja legislación tributaria, con profusión de tributos y varios regímenes de promoción que, sin una armonización de conjunto sólo se constituyeron en paraísos fiscales, que en alguna medida contribuyen a la industrialización de zonas menos favorecidas del país, pero al mismo tiempo conforman un panorama donde la insuficiencia de los recursos genuinos deriva en la utilización del impuesto inflacionario, consecuencia seguramente no querida pero inevitable dentro de este desorden. Basta recordar que algunos de los regímenes de promoción otorgaron como franquicia el diferimiento del pago de impuestos sin actualización, para comprender que en el agudo proceso inflacionario que se vive, el sector de menores recursos es el más perjudicado.

La inflación constituye a su tiempo otro de los factores distorsionantes de la tributación, ya que sus correlatos necesarios en el orden impositivo (actualización y ajuste por inflación) tratan de corregir los efectos negativos pero no siempre lo consiguen. Naturalmente no es lógico pensar ahora en eliminar esos mecanismos de corrección, pero sí conviene que nos detengamos a señalar su incidencia dispar, cuando se benefician sectores o empresas con incrementos de precios superiores al promedio, lo que alienta el incumplimiento del resto o simplemente se benefician quiénes más perjudican a la economía en este contexto inflacionario.

El elevado incumplimiento de las obligaciones tributarias, se advierte con claridad, comienza en 1981, luego de la reforma llamada "de la generalización del I.V.A.", y si analizamos la serie que mide la presión fiscal en la última década encontramos que, después de caer en 1974, crece ininterrumpidamente hasta 1980 para declinar nuevamente y llegar en 1983 a niveles cercanos a los de 1976; conforme el siguiente detalle:

1974: 23,70	1979: 27,25
1975: 16,57	1980: 28,24
1976: 19,12	1981: 24,46
1977: 23,16	1982: 21,62
1978: 26,09	1983: 20,55

(Ingresos consolidados del sector público, incluyendo tributos nacionales, provinciales, paratributarios y de seguridad social, expresados en % del P.B.I.).

Con tan pronunciada caída de la presión fiscal global se hace necesario actuar en dos aspectos para reducir el déficit: corregir la evasión y disminuir el gasto público.

Cuáles serán los instrumentos para tales objetivos? Naturalmente debe buscarse en la orientación política que conforma la filosofía del equipo gobernante.

Es prioritario, desde este enfoque, eliminar la regresividad de los tributos, determinada por la participación relevante que tienen los impuestos sobre los consumos y disminuir los gastos en los que el estado incurre por inercia. No constituye objeto del presente análisis pormenorizar en este segundo aspecto, pero conviene recordar que se limitaron fuertemente los gastos de viajes al exterior, las compras de bienes muebles, inmuebles, naves, aeronaves y los gastos de publicidad, todo lo que se evidenció en una drástica caída de los requerimientos de Tesorería que en el período diciembre 1983 – marzo 1984 disminuyó en un 60% aproximadamente.

Para retomar el aspecto de la reforma impositiva a partir de la situación calificada como de régimen regresivo, debemos puntualizar que tal regresividad en alguna medida estaba atenuada por imposiciones sobre algunos bienes suntuarios o prescindibles.

Desde el comienzo de su gestión el gobierno constitucional, actuó decididamente eximiendo del I.V.A. a determinados alimentos y medicamentos, al tiempo que se incrementó la alícuota que se aplica sobre bienes prescindibles o suntuarios, sector que también fue más fuertemente gravado en impuestos internos.

Por otra parte se reimplantó el recurso del FO.NA.VI. (Fondo Nacional para la Vivienda) un tributo que grava las nóminas salariales a cargo del empleador, lo que no presenta problemas ya que se restableció en un momento en que la desocupación o subocupación laboral evidenciaban índices de franca recuperación. Conviene resaltar que el destino fiscal de estos recursos responde al concepto de solidaridad social al destinarse a la construcción de viviendas económicas.

No se descarta, en las actuales circunstancias, que dada la situación de emergencia, sea necesario proponer al Congreso Nacional la consideración de tributos que permitan una rápida recuperación de niveles de recaudación acordes con las actuales necesidades, de fácil control y escasas posibilidades de evasión, aún cuando no cumplan con los objetivos de corregir la regresividad del sistema.

Dentro de estas líneas se inscribe el incremento aplicado al impuesto a la transferencia de combustibles, particularmente a las motonaftas, que proveen de recaudación rápida, con control centralizado, tiene una muy escasa incidencia en el costo de bienes y servicios, alienta la utilización racional de los vehículos y consecuentemente posibilita ahorro de combustibles, y es soportado por quienes en algún modo evidencian capacidad contributiva.

En lo que respecta a los recursos aduaneros, la política fiscal se inscribe en un marco más amplio de política económica, corrigiendo el tipo de cambio real a través de modificaciones en las retenciones o los reembolsos según evolucionen los precios internacionales y de acuerdo a la necesidad de lograr un saldo en la balanza comercial adecuado para afrontar compromisos internacionales.

Como expresión sintética de los objetivos de corto plazo, la acción está orientada a corregir el elevado incumplimiento de las obligaciones tributarias, ya que no puede implementarse un sistema justo sobre la base de las posibilidades que otorga una administración insuficiente o ineficiente, que permite al evasor desarrollar una competencia desleal y en general una mala asignación de recursos.

Para ello se cuenta con una dotación de personal en el organismo recaudador que está preparado para realizar tareas de fiscalización mediante procedimientos que no dieron los resultados esperados (diferencias de inventarios, sistema de punto fijo); sin la información básica imprescindible. Se propone corregir los procedimientos, dotando al personal dedicado a tales tareas de la preparación adecuada, con datos almacenados utilizando la moderna tecnología informática y capacitando a los inspectores para que puedan auditar los registros de las empresas que también utilizan la computación.

Constituye un objetivo el cumplimiento voluntario por parte de los contribuyentes, pero para ello es necesario contar con elementos técnicos y dotación humana suficientemente capacitada para que el riesgo subjetivo del contribuyente sea cierto, para lo que se están desarrollando los cursos de acción adecuados.

Al mismo tiempo se celebran acuerdos entre organismos recaudadores (Nación y Provincias) para posibilitar un mejor control integral.

Se proyecta corregir las evasiones que permiten los secretos financieros y bursátiles, que se han constituído en refugios para impedir una adecuada fiscalización.

Se hace necesario asimismo corregir la lentitud que se observa en el tratamiento de las causas ante el Tribunal Fiscal de la Nación, por falta de integración de sus salas, al tiempo que se estudia la posibilidad de permitir que el contribuyente del interior pueda acceder a plantear sus cuestiones ante este Tribunal especializado, habilitando todas las mesas de entrada del organismo recaudador como ente notificador.

Como acción inmediata de la reforma se procura, simplificar el sistema eliminando las causas de conflictos por interpretaciones o normas confusas y dispersas.

Se acentuarán los gravámenes progesivos. Para lograrlo se ensanchará la base del impuesto personal a la renta, incluyendo en ella a los dividendos y utilidades – antes excluidos de su base – de sociedades consideradas de capital, dando un crédito por el impuesto societario pagado. Se armonizará con este tratamiento de los dividendos, el que se dé a los resultados de la venta de acciones actualmente extentos del impuesto. Con igual propósito las inversiones empresariales, que se hallan también fuera de la base del impuesto sobre el patrimonio de los individuos, se incorporarán a ella y el impuesto a los capitales pagado por las empresas se computará como pago a cuenta de aquel gravamen.

Se utilizarán incentivos que permitan la reinversión de las utilidades hacia actividades productivas o socialmente necesarias.

Se corregirán los regímenes de promoción industrial, para llegar a un sistema armónico que permita aprovechar las ventajas comparativas estáticas o dinámicas existentes.

II. COORDINACION ENTRE DISTINTOS NIVELES DE GOBIERNO

Por su organización constitucional, la República Argentina estructura la coordinación fiscal entre distintos niveles de gobierno con tributos reservados por las provincias, otros que son facultad de la Nación y otros que pueden ser recaudados en forma concurrente por ambos niveles.

Desde 1935 se vienen celebrando acuerdos o convenios entre la Nación y el conjunto de provincias acerca de la manera de corregir superposiciones y anarquías, delegando en la Nación la facultad de cobro y estructurando un mecanismo para distribuir su producido.

Conviene hacer una síntesis del proceso por el cual se arriba al actual esquema de distribución tanto primaria (que trata de lograr el equilibrio vertical) como de la secundaria (que obedece al objetivo de lograr el equilibrio horizontal, entre las provincias). En el año 1980 la participación relativa de los gastos del gobierno central (58,5%) con relación a los de los gobiernos provinciales y municipales (41,5%) indicaban que Argentina se situaba en ese aspecto en un nivel similar al de los países desarrollados.

Con anterioridad a la sanción de la Ley No. 20.221 del 21/3/73, la coparticipación entre Nación y Provincias se encontraba vigente a través de tres regímenes diferentes, (leyes Nros. 14.060, 14.390 y 14.788).

La Ley No. 14.060 (1951) creaba el impuesto nacional que sustituía al gravamen provincial a la transmisión gratuita de bienes, aplicable a las sociedades de capital. El método de distribución entre la Nación y las Provincias se realizó sobre la base del principio de radicación económica de los bienes objeto del Tributo.

La Ley No. 14.390 (1954) unifica el régimen de distribución, para lo recaudado en concepto de todos los impuestos internos nacionales. Se establece la siguiente distribución primaria, que trata de alcanzar:

Nación = 54%
Provincias = 46%

Por su parte, la Ley No. 14.788 (1959) determina a partir del 1/1/59, una nueva distribución de lo recaudado por impuestos a las ventas, a los réditos, a los beneficios extraordinarios y a las ganancias eventuales. La participación de las Provincias pasaba progresivamente de una 28% en 1959, a un 36% en 1963.

Del producido total de las leyes mencionadas, el conjunto de Provincias recibía un 37%.

La sanción de la Ley No. 20.221, que unifica el régimen anterior de tres leyes convenio, produjo un incremento del 40% en los montos percibidos por el total de Provincias en 1973, al pasar su participación de un 37% a un 48,5%.

La nómina de tributos encuadrados en la mencionada norma legal es la siguiente: a los réditos, a las ganancias eventuales, a las tierras aptas para la explotación agropecuaria, a la regularización patrimonial, a la posesión neta de divisas, al parque automotor, a las ventas, a la venta de valores mobiliarios, internos, adicional a los aceites lubricantes y sustitutivo del gravamen a la transmisión gratuita de bienes:

La distribución primaria a aplicarse es la siguiente:

Nación	48,5%
Provincias	48,5%
F.D.R.	3%

La distribución secundaria se estableció en base a:

a) 65% directamente proporcional a la población.
b) 25% en proporción per capita, a la brecha de desarrollo, entre cada jurisdicción y la región más desarrollada.
c) 10% entre las provincias con densidad de población por debajo del promedio total y en proporción a dicha diferencia.

El régimen de la Ley No. 20.221 se modifica sustancialmente a partir de la sanción de la Ley No. 22.293 (30/9/80), que suprime los aportes patronales para el Sistema Nacional de Previsión y FO.NA.VI.

Por otra parte, para el financiamiento de las distintas cajas nacionales de seguro social, que ahora se encontraban sin aportes patronales, se establece que la Nación procederá a tomar fondos del total recaudado por el régimen de coparticipación antes de realizar la distribución primaria entre ella y las Provincias.

Cabe destacar que por la Ley No. 22.294 se procedió a la generalización y modificación de las tasas del Impuesto al Valor Agregado.

Puesto que lo ingresado por tal reforma del I.V.A. no compensó lo que extraía la Nación para el financiamiento de sus cajas sociales, las Provincias vieron reducida así su participación. Dada esta situación inequitativa, se sancionó la Ley No. 22.453 que permite a las Jurisdicciones provinciales participar junto con la Nación en la extracción de fondos con idéntico fin.

A pesar de esto último, las Provincias no pudieron lograr los niveles anteriormente alcanzados. Si a estos sumamos una caída del 6% y 4% en el P.B.I. para los años 1981 y 1982, se comprenderá a qué obedecen las mermas registradas en dichos años.

El siguiente cuadro muestra comparativamente, el comportamiento de la recaudación total de impuestos coparticipados y los montos netos a distribuir, previa deducción de los requerimientos para el Sistema de Seguridad Social. Puede observarse como afectó en 1981 la vigencia de la Ley No. 22.293, pues mientras la recaudación total aumentó, en términos reales, en un 1%, la coparticipación a las provincias cayó en un 37%.

– En miles de millones de $a de 1980 –

Años	*Recaudación total*	*Variación (%)*	*Seguridad social**	*Montos coparticipados**	*Variación (%)*
1973	11.570	–	–	11.570	–
1974	15.134	31	–	15.134	31
1975	9.040	–40	–	9.040	–
1976	13.589	50	–	13.589	50
1977	20.606	51	–	20.606	51
1978	19.348	– 7	–	19.348	– 7
1979	19.107	–	–	19.107	–
1980	23.182	20	2.394	20.788	8
1981	23.433	1	10.268	13.165	–37
1982	19.664	–16	8.825	10.839	–18
1983	19.410	– 1	10.843	8.567	–21

* *Fuente:* Banco de la Nación Argentina.

La acentuada disminución que se advierte a partir de 1981 en los montos netos coparticipados se agravan si consideramos que entre 1978 y 1981 fueron transferidos servicios de la Nación a las Provincias en áreas de Salud, Educación, Provisión de Agua Potable, de Riego, Servicios Cloacales y Caminos.

Se hace necesario cuantificar la incidencia de tales transferencias para restablecer nuevamente el equilibrio vertical, sin desconocer que del mecanismo a convenir deben las Provincias ajustar también la distribución secundaria, para lograr un equitativo equilibrio horizontal.

General Outlook for a Tax Reform in Argentina

By Norberto A. Bertaina

I. TAX REVENUE

The situation in which the Argentine economy found itself by the end of 1983 required substantial changes which should be carried out in accordance with the objectives of the present democratically elected Government and which should contribute to shape the country pattern that Argentina should and must pursue.

The situation resulted from a high fiscal deficit, almost 15% of GNP as compared to 14.29% for 1982, representing a real increasing trend since the deficit was about 20% of GNP by December.

The objectives set out in the 1983 National Budget were to reach a deficit level of about 8% of GNP; a goal that was not reached for two different reasons, i.e. revenue decreased by 3.31% while expenditure increased by 3.45%.

At the same time, it may be said that the decrease in revenue actually collected in comparison to the budget estimates is the result of a lower amount of taxes collected which may be broken down in terms of GNP as a decrease of 2.5% for taxes and 0.81% for prices and tariffs.

This general reduction of revenue is to be allocated among the various jurisdictional levels, i.e. 1.8% for the Nation, 1.12% for the Provinces and 0.19% for the Social Security System.

With respect to non-tax revenue, which is mainly represented by prices and tariffs charged by government enterprises and decentralized governmental bodies, it may be argued that a significant drop in revenue may be due to the fact that during 1983 Provinces collected only 70.81% of the estimated amounts.

On the other hand, tax revenue of the national jurisdiction suffered in 1983 a substantial reduction with respect to Federal "coparticipation taxes", so that it not only produced its negative effects upon the revenues of the National General Treasury but also made the financial problems of the Provinces and of the Municipality of Buenos Aires more acute. The financial problems of the Provinces and of the Municipality of Buenos Aires became particularly serious because they – as a whole – have suffered since 1980 substantial reductions in real income which should have been taken care of by large amounts from Treasury funds. Therefore, while in 1980 their revenue represented 41.94% of the total, by 1983 it only reached 28.72%. To correct this situation the Treasury had to come to their rescue with an amount equal to 30.28% of the total expenditure of all local governments.

Two extreme cases may be mentioned: in 1983 tax revenue covered only 6.4% and 7.3% of salary expenditure of 2 Argentine Provinces, whereas the Federal District obtained a revenue equal to 126.4% of the salaries paid. As a consequence of this deterioration of the provincial finances, the Provinces started to accumulate unpaid payment orders which required in December 1983 a money transfer of 6,000.8 million pesos. This figure is particularly illustrative if one compares it with the amount of 951 million pesos which the National Treasury had to use in order to finance the Provinces in July of the same year.

During the past few years changes in the financing of the Social Security System were indicated as a determinant cause of such deterioration, mainly because in 1980 employers' contributions were abolished. At the same time the Value Added Tax (VAT) was modified as well as the "coparticipation system". Although this cause exerted some influence it does not give a satisfactory explanation for the inadequate financing of the local treasuries. This is clearly demonstrated when we analyze what happened in 1983. If the Federal "coparticipation system" had been in force up to 5 October 1980, the Provinces and the Municipality of Buenos Aires would have received an amount of 24,991 million pesos and if it is true that the real transfer amounted to a total of 15,696 million pesos it is equally true that through other Treasury contributions they received a total additional amount of 23,385 million pesos. It is, therefore, clear that the collection of "coparticipation taxes" had also been declining during this period of time, resulting in the need for greater monetary issue so as to meet the obligations of the public sector.

Having thus analyzed the failure of Government finances we must necessarily arrive at the conclusion that the real crisis in which we find ourselves is mainly determined by two factors: the decreasing economic activity and the failure of both the tax system and the tax administration.

In particular, as regards taxation it is necessary to point out that we have found a political system in which, due to the successive reforms at various levels, both the private sector as well as the tax administration are faced with a confusing situation in which it is not possible to plan future projects.

Fiscal control was mainly based on the individual efforts and the competency of the revenue agents who were not able to draw on data which should be at the disposal of tax inspectors in carrying out their duty and who had to apply procedural methods which at the least might provoke negative reactions from the taxpayers. Thus we are faced with complex tax legislation with a great number of taxes and several incentive schemes which were not harmonized among themselves. Thus we have in fact created tax havens, which to some extent contributed to the industrialization of less developed areas in the country, but which at the same time formed the background against which the lack of real revenue resulted in the inflationary issue of money. It goes without saying that this is an undesirable but inevitable consequence of the present disorder. Suffice it to remember that under some of the incentive schemes non-discounted tax deferrals are granted, just to understand that, in the acute inflationary process we have at hand, it is the lowest income group which suffers most.

In its turn inflation constitutes another distorting factor with respect to taxation since it necessarily requires the introduction of adjustments (discounts and adjustments of taxable income for inflation) which may correct the negative effects but which do not always achieve their goal. Of course, it would not be logical to envisage the abolition of these correction measures, but one should here point out their unfair incidence in those cases where certain sectors or enterprises benefit from price increases which are higher than average, thus encouraging others not to meet their obligations. Unfairness exists also where such sectors or enterprises, from an inflationary point of view, benefit by damaging the economy more seriously than others.

It may be clearly demonstrated that after VAT became a general tax in 1981, non-compliance with respect to taxes increased. If we analyze the data showing the tax pressure throughout the last decade we find that after 1974 tax pressure decreased although it gradually increased again up to 1980 after which year it again decreased and in 1983 we were back to the 1974 level. See Table I below.

Table I

1974: 23.70	1979: 27.25
1975: 16.57	1980: 28.24
1976: 19.12	1981: 24.46
1977: 23.16	1982: 21.62
1978: 26.09	1983: 20.55

(Consolidated Public Sector Income, including national and provincial taxes, surtaxes, and social security taxes, all of them stated as a percentage of GNP).

With this substantial decrease of general fiscal pressure it is necessary to initiate action in two different directions, i.e. to combat tax evasion and to reduce public expenditure.

What instruments should be used to achieve these goals? Of course, they should be found within the political objectives which constitute the philosophy of the present Government. From this point of view absolute priority should be given to eliminating the regressivity of the tax system which is mainly caused by the influence of taxes on consumption and also to reducing unnecessary government expenditure which is incurred through sheer inertia. However, it would be outside the scope of our present analysis to enter into details on this second subject. Suffice it to say that we have greatly restricted expenses for travel abroad as well as for the purchase of movable and immovable goods, ships, and aircraft and also publicity expenses. This represented a drastic reduction of Treasury requirements (during December 1983–March 1984 these were reduced by approximately 60%).

If we return for a moment to that aspect of tax reform which we have indicated as a regressive system, we should point out that such regression was to some extent mitigated through the taxation of luxury goods.

Since the new constitutional government took over, certain foodstuffs and medicines were exempted from VAT and simultaneously the rate for luxury goods was increased (these goods are also subject to high internal consumption taxes).

On the other hand the FONAVI (National Housing Fund) was restored. Although this represented the imposition of a payroll tax on employers it did not cause any problems because it was introduced at a moment when unemployment showed a trend to real recovery. It may also be pointed out that this tax is a national solidarity tax since its revenue is destined to finance low-priced house construction.

It should not be disregarded that under the present critical situation it will be necessary to propose that the National Congress consider the introduction of such taxes which allow for a rapid recovery of the level of tax collected, taking into account the present requirements. Such taxes should be easy to control and at the same time offer fewer evasion possibilities, even if they did not meet the objective of reducing the regressivity of the system.

Along these lines we may include the increase of fuel transfer taxes (mainly motor fuel) which permits rapid collection, centralized tax control and which has no significant incidence on the cost of services and goods. It would also encourage a more rational use of vehicles and consequently contribute to petrol saving. Finally, it would be levied on those taxpayers who show a greater taxable capacity.

With regard to customs revenue, fiscal policy has been formulated in a wider framework by correcting the actual rate of exchange by modifying the amounts withheld or refunded in conformity which the development of the international price level and also in conformity with the need of reaching an adequate net balance of trade result in order to meet international obligations.

If our short-term objectives are briefly summarized one could say that our action should be directed to correcting taxpayer compliance, since a fair tax system cannot be implemented if an inefficient tax administration offers taxpayers the possibility of tax evasion and of disloyal competition which will generally result in inefficient resource allocation.

For that reason the revenue offices charged with the collection of taxes have been allotted additional staff who are ready to carry out tax audits that did not yet bring about the expected results (inventory differences, fixed point system) because the required basic information is lacking. The proposal is to improve such procedures by giving the personnel charged with such tasks adequate training using data storage systems offered by modern information technology so that they may be able to carry out the required audits of records of those companies using computers.

The real objective is that taxpayers will eventually voluntarily meet their obligations. However, for this it will be necessary to have adequate technical equipment as well as a sufficiently trained staff so that taxpayers will run a real risk if they do not comply. For this purpose an adequate course of action should be set out.

At the same time agreements should be concluded between the collection agencies at the national and provincial levels in order to permit better fiscal control. Another objective is the combatting of tax evasion connected with secret financial and stock exchange operations because these constitute a real tax shelter for those persons who try to avoid proper tax audits.

It is also necessary to speed up the procedures before the National Tax Court (Tribunal Fiscal de la Nación) which are much too slow because of the lack of integration between its chambers. At the same time it will be necessary to study the possibility for resident taxpayers to have access to that specialized Court and to present their problems there. The reception desks of the tax offices should be authorized as notifying agents.

As an immediate course of action the reform aims at simplifying the system by eliminating the causes for conflicts resulting from misleading interpretations and confusing provisions. Progressive taxes will be increased by enlarging the taxable base of personal income tax which will include dividends and earnings – previously excluded – of entities considered to be corporations. A credit for the corporate income tax paid will be granted, however. This treatment of dividends will be in line with the taxation of gains at the sale of shares, which is at present tax exempt. For that reason, corporate investments, which are also outside the basis of the individual net worth tax, will be so included and the capital tax due by companies will be computed as a payment on account of that tax. Incentives will be used to allow gains to be reinvested in productive activities or activities which are socially needed. The industrial incentive system will be corrected so as to arrive at a harmonious system enabling us to take into account static and dynamic comparative advantages.

II. THE COORDINATION AMONG DIFFERENT GOVERNMENT LEVELS

Due to its constitutional organization the Argentine Republic has structured its taxes at different governmental levels. Some taxes are exclusively reserved for the Provinces, some others may only be imposed by the Nation and again some others may be collected at both levels. Since 1935 agreements have been concluded between the Nation and all the Provinces to avoid double taxation, delegating the authority to collect tax to the National Government and by setting up a revenue sharing system. It may be useful to sketch the process through which Argentina arrived at its present distribution system which primarily rests on a so called "vertical equilibrium approach" and secondly tries to achieve "horizontal equilibrium" between the Provinces. During 1980 the share of the expenditure of the Central Government (58.5%) in relation to the Provincial and Municipal Governments (41.5%) showed that in this respect Argentina could be placed at the level of a developed country.

Before Law 20,221 of 21 March 1973 was enacted the coparticipation system between the Nation and the Provinces was based on three different regimes laid down in Laws 14,060, 14,390 and 14,788. By virtue of Law 14,060 of 1951 a national tax was created which replaced the provincial substitute inheritance tax imposed on corporations. The distribution method between the Nation and the Provinces was based on the "economic location" principle of the goods subject to the tax. Law 14,390 of 1954 consolidated the distribution or sharing system with respect to the collection of total internal consumption taxes. The following primary distribution was established:

- Nation: 54%
- Provinces: 46%.

Law 14,788 of 1959 in its turn established as from 1 January 1959 a new distribution system with regard to the collection of sales and income taxes and the tax on gains. The share of Provinces increased from 28% to 36% in 1963. All Provinces together received 37% of the revenue thus obtained. These three laws were consolidated by Law 20,221. During 1973 the Provinces collected 40% more of the total amount because their sharing rates went up from 37% to 48.5%.

The taxes listed in the above law were: income tax, capital gains tax, tax on unimproved land, sales tax, tax on income from immovable property, internal consumption tax, tax on income from lubrication oil, substitute inheritance tax, etc.

The primary distribution was as follows:

- Nation: 48.5%
- Provinces: 48.5%
- F.D.R.: 3%

The secondary distribution was based on the following criteria:

(a) 65%, directly proportional to population;
(b) 25%, as a per capita proportion related to the difference in development between each of the different jurisdictions and the most developed one;
(c) 10%, for those Provinces whose population density is below the average and directly proportional to such density.

The above system established by Law 20,221 was substantially altered by Law 22,293 of 3 September 1980 which abolished the employers' contributions to the National Social Security System and to the FONAVI. On the other hand, it was established that the National State should contribute to the National Social Security Boards, which were no longer financed by the employers' contributions. This should be effected by the National State taking a certain amount from the total tax collected under the coparticipation system before the primary distribution between the Nation and the Provinces. It may be underlined that by virtue of Law 22,294 VAT became a general tax and its rates were changed. Since, however, the resulting additional amount of VAT thus collected did not compensate for the additional amount to be taken from the total tax collected under the coparticipation system to finance the National Social Security Boards, the share of the Provinces in the total revenue collected was reduced. To remedy this unfair situation Law 22,456 was enacted which provided for the Territorial Jurisdictions to share with the National State in the collection of funds for identical purposes. However, the Provinces were not able to reach previous levels. If it is also appreciated that during 1981 and 1982 there had been a decrease of 6% and 4% in GNP, respectively, the reasons for that reduction in those years may be clearly understood.

Table II compares the development of total taxes collected under the coparticipation system and the net amounts distributed after deduction of the amounts required by the Social Security System. It may be seen in which manner in 1981 Law 22,293 affected the entire fiscal system. Total taxes collected increased in real terms by 1% whereas the share of the Provinces in the coparticipation system decreased by 37%.

The decrease shown since 1981 in the distributions under the coparticipation system is even worse than at first sight appears, since between 1978 and 1981 certain services formerly rendered by the Nation were transferred to the Provinces such as health services, education, supply of water, sewerage, drainage, highways, etc.

It is, therefore, necessary to estimate the incidence of such transfers to restore the "vertical equilibrium" without neglecting the fact that under the mechanism agreed upon Provinces should also adjust the secondary distribution, so as to attain a fair "horizontal equilibrium".

Table II

1980 (1 million pesos)

Year	*Total tax collected*	*Variation (%)*	*Social security**	*Net amount coparticipated**	*Variation (%)*
1973	11,570	–	–	11,570	–
1974	15,134	31	–	15,134	31
1975	9,040	–40	–	9,040	–
1976	13,589	50	–	13,589	50
1977	20,606	51	–	20,606	51
1978	19,348	– 7	–	19,348	– 7
1979	19,107	–	–	19,107	–
1980	23,182	20	2,394	20,788	8
1981	23,433	1	10,268	13,165	–37
1982	19,664	–16	8,825	10,839	–18
1983	19,410	– 1	10,843	8,567	–21

* *Source:* Argentine National Bank.

Taxation in Latin America

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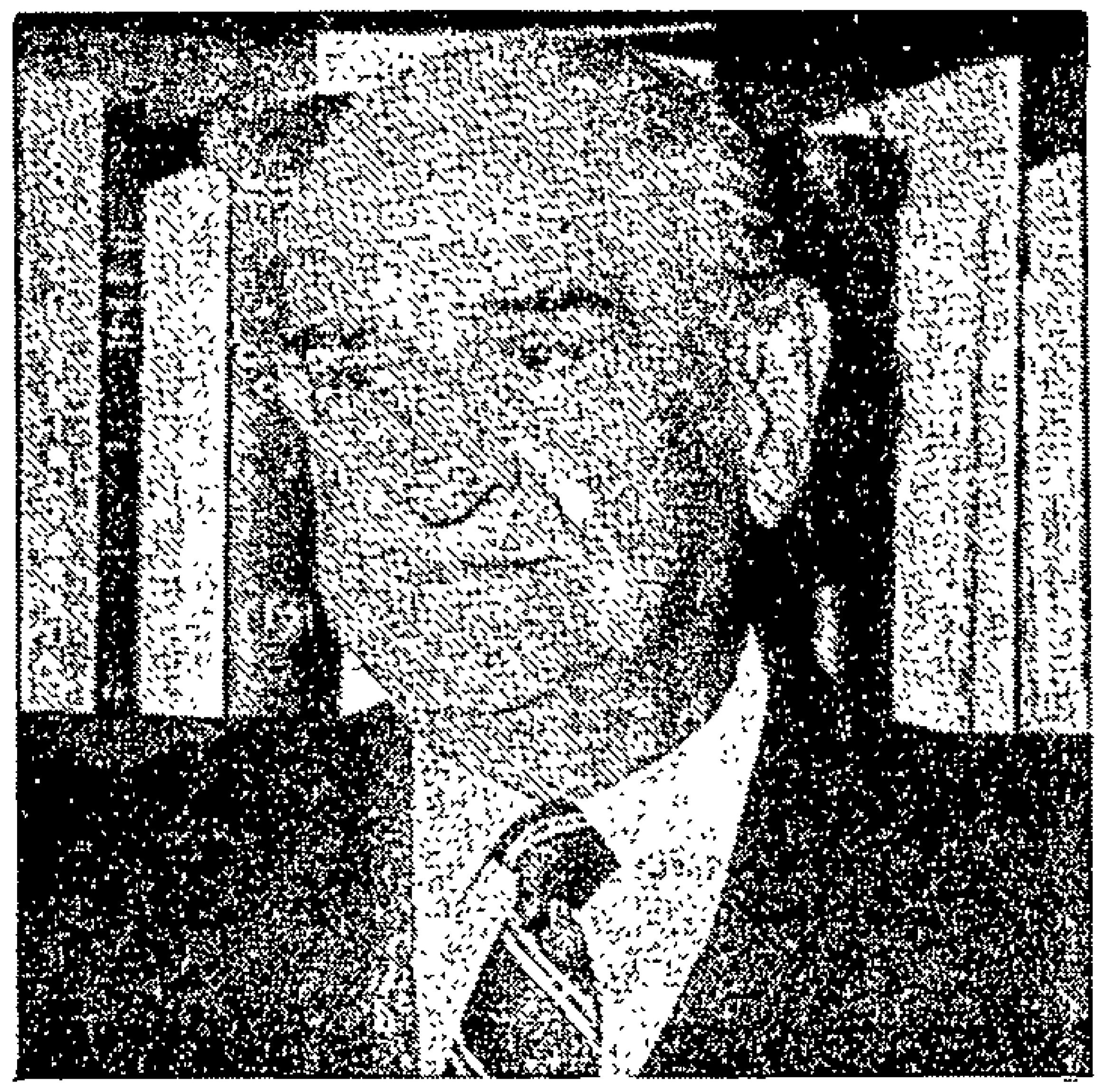

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Published numerous books and articles in Uruguay and abroad on tax matters.

I. INTRODUCTION

1. Basis of the constitutional legal system

1.1. *Sources*

Latin American taxation systems are organized within the framework of constitutions which, for obvious reasons, limit the jurisdiction of the government bodies that administer taxes.

The first constitutions approved in the XIXth century, when independence was achieved, were undoubtedly based on Montesquieu's theory of the separation of powers and the political ideas, predominant in the XVIIIth century, that were incorporated in the Constitution of the United States of America of 1776 and in the constitutions approved during the French Revolution (which exercised an undeniable influence on the American Constitution). The Spanish Constitution of 1812 also influenced the constitutions of some countries. Their texts provided for a strict separation of legislative, administrative and jurisdictional functions concentrated in the three corresponding bodies, within which all government entities acted.

1.2. *Evolution*

The evolution of political ideas, particularly as regards the objectives of contemporary Government and, specifically, as regards taxation, its increasing importance and complexity, gave way to reforms that diminished the rigidity of the traditional system. With respect to our subject matter, these modifications may be grouped into two categories: first, conferring on the Executive Body certain legislative powers (the right to take the initiative – sometimes of an exclusive nature and in certain cases special powers for approving acts which have the force of law); secondly, the establishment of jurisdictional bodies specialized in taxation, which in some countries are established separately from the Judicial Body, either as totally independent entities, or as part of the Executive Body, although with relative and varied independence particularly as regards active administration.

To this constitutional situation were added unorthodox elements. These resulted partly from political upheavals, so frequent in Latin America, and partly from legislation which ignored the fundamental principle of the separation of powers. Legislative powers were delegated to the Executive Body (contrary to the constitutions) by granting powers to the executive to approve tax laws, which were strictly part of formal law. Also, the withdrawal from the Judiciary – in favor of the Executive Body – of certain jurisdictional functions.

It must be pointed out that in recent decades, these legal flaws have been eliminated under the influence of a reputable doctrine, through constitutional reforms and the approval of an organic legislation of a general nature. It may be stated that the present situation is substantially in conformity with constitutional principles, affording taxpayers sufficient guarantees, without being detrimental to the effectiveness of the administration.

1.3. *Distribution of legal powers*

In general terms all countries allocate tax resources to smaller territorial divisions (States, Provinces, Departments, Municipalities) and frequently grant them legislative powers. In others, these powers are maintained by the Central Government and the resources assigned to such divisions result from their participation in revenue or subsidies.

The most obvious examples of local autonomy are federal governments, particularly in Argentina, Brazil, Mexico and Venezuela. However, there are also examples of unitary governments which have granted certain territorial divisions the right to impose taxes. Such is the case in Uruguay, with a constitutional regulation, begun in 1917 and changed several times, but because of its being rather unsatisfactory, new reforms are anticipated.

In *Argentina*, the federal system has deep historical roots. The Constitution of 1853, which is still in force, organized the system in a manner similar to that of the United States. In principle, powers are granted to the provinces and, therefore, these possess all powers not delegated by the Constitution to the Federal Government. Without going in detail into the characteristics of this system, it may be stated that generally the *provinces* have (a) the exclusive right to impose direct taxes (among them income tax); however, the Constitution provides that Congress may in exceptional circumstances (defense, common security and general proper functioning of the Government) impose direct taxes for a specific period of time; (b) have the right, jointly with the Federal Government, to impose indirect or excise taxes; (c) the Federal Government maintains, by express constitutional provision, the exclusive and permanent power to levy customs duties. This system has in practice undergone significant modifications, based on an extensive interpretation of the special powers of the Federal Government as regards direct taxes (in particular income tax), and in agreements between the Provinces and the Nation, as regards indirect taxes, including VAT. Such agreements are actually expressly included in the "coparticipation system" organized by the National Act of 1973 (in force until 31 December 1983 and extended for a one year period). This Act states the various rights and obligations of the Provinces and the Nation and the control and supervision entities whose decisions are binding over both sectors.

Brazil's system has undergone several constitutional amendments. According to the amendments approved up to 1981, the legislative power of taxation is distributed between the Union, the States, the Federal District and the Municipalities, and the Constitution defines the various taxes that may be imposed by each of them. The imposition of the most important taxes is entrusted to the Union (customs duties, income tax, rural territorial property, industrialized products) which may establish other taxes provided "they do not have the same tax base" as the taxes which, according to the Constitution, are the exclusive responsibility of the States, Federal District or Municipalities (mainly the transfer of real estate, circulation of goods and urban real estate).

The *Mexican federal system* has also been subjected to several alterations and even interruptions. This system, established by the Constitution of 1943, is, like the Argentine one, based on the U.S. system. It provides that "all powers not expressly granted by this Constitution to federal officials are understood to be reserved to the States". The meaning of this regulation is unclear with respect to whether or not it encompasses taxation, there being contradictory doctrine and jurisprudence in this regard. Other constitutional provisions give the system a complex nature, a general description of which, in accordance with the most authoritative jurisprudence, would be: (a) joint rights of the Federation and States as to the greater part of revenues; (b) an exclusive right of the Federation over certain matters, which could be delegated by the latter to the States; and, lastly, (c) a restriction of the States' taxation power. Also, as in Argentina, efforts have been undertaken to avoid double taxation and, in general, to coordinate the legislation of the various legal entities through National Fiscal Agreements and, subsequently, through the Fiscal Coordination Acts of 1953 and 1978.

The 1961 *Constitution of Venezuela* expressly distributes the tax legislative powers among the National Government, the States and the Municipalities. The National Government is granted the right to tax income and mines and hydrocarbons (including the applicable rates), i.e. the most important in the country, and give the system a centralist nature. In addition, there are taxes such as those applied on capital, inheritance and gifts, and the import, production and consumption of certain goods. Municipalities are granted the power to levy taxes on urban real estate, public shows, business and industry licenses and others of lesser importance. The States, which are considered by the Constitution as autonomous political entities, have the minimal residual jurisdiction, with an express prohibition on the establishment of interstate customs duties and certain types of excise taxes.

In conclusion, it may be said that federal states have shown an increasing trend toward the centralization of their tax legislation. In particular, this applies to the more important taxes, the means for avoiding double taxation, for reducing the diversity of solutions with respect to the same taxes and the implementation of tax policies that take into consideration the general interest.

2. General concepts of tax legislation

2.1. *Historical evolution*

The beginning of organic legislation on taxation may be set in the Thirties. One of its main sources was the German Tax Statute of 1919 (Reichsabgabenordnung) and the new autonomist concepts diffused throughout Latin America, particularly through the Italian doctrine.

In 1936, the "act on Fiscal Justice" was approved in *Mexico,* followed in 1938 by the approval of the "Fiscal Code of the Federation", which systematically regulated the material, procedural and penal regulations of tax law. Among its most significant innovations one may mention the establishment of a specialized Fiscal Court which, even though set within the Executive Body, had great autonomy and offered adequate guarantees as its decisions could be appealed to the Supreme Court. It was subjected to successive reforms, particularly in December 1981.

In the same decade, a general law was approved in *Argentina,* called "Procedure for the Application, Receipt and Verification of Taxes", which regulated significant aspects of tax law and included the most advanced doctrine of the period, such as, for example, the interpretation of tax regulations. This act, identified as Act No. 11,683, is, in amended form, still in force. Several years later, in 1948, the Fiscal Code of the Province of Buenos Aires was approved. Using an improved legislative technique, it systematically regulated all legal aspects of taxation and served as a model to several codes of other provinces.

In the Forties and Fifties, significant progress was made in codification in Argentina, Brazil and Uruguay, through projects prepared at university and administrative levels. These may be considered as the direct background to the initiative of the Joint OAS/IDB/ECLA Taxation Program for formulating a Model Tax Code for Latin America (CTAL Model), which was entrusted to a Committee formed by the experts who had participated in such projects with the cooperation of experts from the other countries.

The CTAL model was prepared during 1964-1967 and there was a reciprocal influence from the Codes of Brazil and Peru, approved in 1966, because members of the respective drafting commissions were, in turn, members or advisers of the Model Committee. Subsequently, it became a direct source – and almost an exclusive one – in nearly all cases of codes being approved: Bolivia, (1970), Costa Rica (1971), Uruguay (1974), Ecuador (1975 which substituted the 1963 Code) and Venezuela (1982).

2.2. *The CTAL Model*

This Model is closely related to the Latin American doctrine, developed during the symposiums held by the Latin American Tax Law Institute, in particular the first four, which dealt in detail with the main legal problems of taxation. This was expressly admitted at the 6th Symposium held in Punta del Este in 1970. The Model confirms the fundamental principles of legality, jurisdiction or jurisdictional protection and legal equality of the parties, inherent in the theories of the division of functions and the granting of guarantees to individuals in constitutional texts. It consists of a Preliminary Title, relating to its scope of application, the characteristics of the tax regulations and their interpretation and the definition of the various kinds of revenues, taxes, fees and contributions. Title II deals with the tax: its legal relationship, structure, origin and payment. Title III regulates aspects relating to violations and sanctions, from the general and specific standpoints. Title IV discusses the administrative or formal aspects, duties and powers of the taxpayers and the Administration, administrative procedures, consultations and appeals against administrative acts. Title V regulates jurisdictional procedures entrusted to specialized and independent entities, as regards analysis of the validity of administrative acts and the procedures for enforcing tax collections, refunds and precautionary measures.

2.3. *Other legislations*

Separate from the codifying trend directed by the Model, one must mention the Code of Chile, first approved in 1960 and amended on several occasions (1970, 1974, 1978 and 1983) which fundamentally deals with various administrative and judicial aspects, even violations and sanctions. Also worthy of mention is the Code of Panama, in force since 1956, and the legislation of Colombia (1977) and Nicaragua (1962) which regulate general aspects of taxation.

II. THE FUNDAMENTAL LEGAL PRINCIPLES APPLIED TO TAXATION

3. The legal principle

3.1. The principle that there is no tax without a law originates, in Latin American legal provisions, directly or indirectly from the constitution and is closely related to the general principle that no one is obliged to do what the Law does not order. This by itself is enough to apply it specifically to tax law, as is the generally accepted interpretation in Argentina, Brazil and Uruguay. In other constitutions, such as that of Colombia, Ecuador, Peru and Venezuela, the principle is specifically expressed to apply to taxes.

3.2. Some constitutions provide for exceptions to the principle that laws must be issued by the Legislative Body. Thus, for example, the constitutions of Brazil and Mexico created a possibility for the Federal Executive Body to approve regulations which have the force of law in specific sectors of taxation. In *Brazil* this provision (Amendment 18 of 1965) is permanent in nature with regard to foreign trade and exchange policy, but only for the purpose of changing the rates and tax bases. The Constitution also provides that in cases of emergency or significant public interest, the President of the Republic may issue decree-laws, on "public finance, including tax regulations". The scope of this provision is extremely controversial as regards the possibility of establishing new taxes which in practice has been used repeatedly.

The reform of 1950 in *Mexico* allowed for the delegation of legislative power on taxation, although limited to modifying "the export and import quotas . . . and for establishing others . . . in order to regulate foreign trade, the country's economy and the stability of national production or to carry out any other effort for the benefit of the country". Other constitutions such as those of Colombia, Peru and Venezuela provide legislative powers in favor of the Executive Body in exceptional cases. In *Colombia* (Art. 76 (12) of the Constitution), although there is no express reference to taxation, Congress may, at the Government's request, "vest special specific powers *pro tempore* in the President of the Republic, when it is necessary or public interest recommends it".

The application of this provision to taxation has been strengthened through repeated practice and is accepted by the Supreme Court, although the validity of such a delegating law is subject to debate. On the occasion of the tax reforms of 1982, decisions were made declaring the unconstitutionality of some measures: the problem was solved by the passing of new laws.

Venezuela also created the possibility of the Executive Body issuing "special measures of an economic or financial nature when public interest may thus require it and when such body has been so authorized by a special act" (Art. 190, ap. 80 of the Constitution).

Peru generally authorizes Congress to "delegate to the Executive Body the power to legislate through legislative decrees on these matters and for the period of time specified by the law granting such authority" (Art. 188 of the Constitution).

Argentina, Ecuador and *Uruguay* have not introduced exceptions. Nevertheless, in Argentina and Uruguay, the Executive Body has frequently been authorized to issue regulations on the determination of rates, granting of exemptions from and elimination of taxes, which a considerable part of the doctrine deems as unconstitutional, since it involves a delegation of authority not provided for in the Constitution. The problem is undoubtedly related to the delimitation of the legal tax principle.

3.3. *Delimitation of the principle.* The simple confirmation of the principle by the Constitution is undoubtedly not enough. The legislative trend is to specify the concept, by making reference to the elements that must necessarily be provided by formal law or by acts which have force of law allowed in the Constitution. This trend is evidenced in the countries that have approved Codes. The general guideline is set by the CTAL Model followed with very little deviation by the Codes mentioned in Paragraph 2.1.

The guidelines of the Model are:

> **Art. 4.** Only the law may:
> (1) establish, modify or eliminate taxes; determine the tax base, set the rate of the tax and the basis for its estimate and indicate the passive subject;
> (2) grant exemptions, reductions or benefits;
> (3) develop the jurisdictional and administrative procedures, inasmuch as these involve a limitation or regulation of the individual rights or guarantees;
> (4) classify violations and determine the respective sanctions;
> (5) determine privileges, preferences and guarantees for tax credits;
> (6) determine the ways of extinguishing tax credits through various systems other than cash payments.

Another problem linked to the effective application of the principle is the determination of the idea of taxes, fees and contributions, which has been evidenced in those countries which, like Brazil, grant various entities unlimited powers to establish fees and contributions and limited powers with regard to taxes. Experience has shown that, in this country (as in others with similar systems), taxes are being established (disguised as "fees" and "contributions") that are not allowed by the constitutional system. The solution has been found in the legal definition of each of the types of taxes, a solution which, in general, has been considered by the Codes.

4. The principle of jurisdiction

4.1. In the first constitutions, the jurisdictional function with regard to taxation was entrusted to the common bodies of the Judicial Body. In practice, one may point out some deviations whereby jurisdictional functions were granted to administrative bodies, a deviation which in many cases was originated by a deficient differentiation between administrative claims and judicial actions, subject to decisions by independent judges.

The evolution of Latin American law in this regard notably started in the Thirties, particularly with the approval of Mexico's Act on Fiscal Justice (see 2.1.) wherein one can easily recognize the influence of Italian doctrine. With it there began a legislative trend that favored the establishment of specialized courts, initially created within the Executive Body, although with unquestioned, though not absolute, independence. The first and most significant evidence of this trend were undoubtedly the creation of the Fiscal Court of the Nation in Argentina in 1960 (inspired by the Mexican Fiscal Court and the U.S. Tax Court, as expressly acknowledged by some of the authors of the project) and the creation of the Fiscal Court of Ecuador (which was incorporated in the 1963 Fiscal Code, and which, according to a statement given by the author of the project, used the Argentine law as source in this specific aspect).

4.2. The doctrine supported this trend since the beginning, especially at the 1st Latin American Symposium on Procedural Law (Montevideo 1957), at the 2nd Latin American Symposium on Tax Law (Mexico 1958), the background of which was incorporated in the CTAL Model, and confirmed at the 7th Portuguese–Spanish–American Symposium (Pamplona 1976). The Model afforded solutions to several types of procedural problems: trials in the case of illegality in administrative acts, tax credits, precautionary measures of a preventive nature to protect those credits and refunds of over-payments. All these regulations are of an exceptional nature as compared to common procedural law (which deals in a systematic manner with the particular aspects of tax processes) and were substantially or integrally incorporated in the codes that followed the Model.

4.3. Perhaps the most important aspect of this kind of legislation involves the position of the courts within the state's structure and their organization and functioning. Three groups may be distinguished:

(1) Specialized courts located within the Executive Body, the decisions of which are of a jurisdictional nature, in conformity with the legislation and which act with varied functional independence, at least with respect to the administration authorities. Their decisions may be appealed to tribunals of the Judicial Body (Argentina, Costa Rica, Chile, Mexico and Peru).

(2) Courts located within the Judicial Body, or closely related thereto, with the characteristics typical of all judicial bodies. Bolivia, Paraguay, Uruguay and Venezuela have courts specialized in administrative or strictly tax matters, as opposed to Brazil and Panama, where there is only specialization with regard to executive action.

(3) Courts established by the constitution, located outside the Executive and Judicial Bodies, although with the typical characteristics of the judicial entities. Such is the case of Colombia's State Council, with its Court specialized in taxes, and of Ecuador with its Fiscal Court, which have reached a high level of specialization and independence, comparable to a Judicial Body. This was also the solution of the Administrative Court of Uruguay until 1981, when it was incorporated into the Judicial Body on the same level as the Supreme Court of Justice.

4.4. As regards the functions of the pertinent bodies to judge the validity of administrative acts, these range from the simple abolition of illegal acts (as in the case of Uruguay), to the possibility of reforming the Act according to the law, as is the case in Argentina, Colombia, Ecuador and Mexico.

4.5. In conclusion, the principle of jurisdictional protection with regard to taxes implied in the early constitutions has been adequately applied through constitutional reform and the legal regulations approved in the past decades.

5. The principle of equality of the parties

The Latin American doctrine has repeatedly maintained that, even though there is no legal regulation which expressly provides for it, the principle of equality is in force as a consequence of the principles of legality and jurisdiction. If the premises are that there is no tax without a law that provides for it and that no one may be a judge in his own legal action, the conclusion must be that both parties in the juridical relationship are equally subject to the law and to the jurisdiction; any special power or privilege that any of them may claim must originate from the law; any controversy that may arise in the application of the law to the specific case must be solved by a qualified judge, unrelated to the parties.

This concept is supported by fundamental principles, particularly the concept of the Rule of Law, the division of functions between the three powers and individual guarantees. As regards tax discipline, it is based on the nature of the legal bond existing between the Government and the taxpayer, which involves a coordinating relationship and not one of power, as maintained by some European theories of the past century.

This legal equality does not prevent the law incorporating exceptional solutions, generally in favor of the government, for ensuring correct application of the law. These deviations also occur in other legal fields, but precisely because of their legal origin, they do not violate the principle of equality.

This principle, thus conceived, is the basis of the CTAL Model and the foundation of many of its solutions, as indicated in the Statement of Reasons. This was also expressly recognized at the 6th Latin American Symposium of Tax Law (Punta del Este 1970).

Therefore, it must be acknowledged as an element of undeniable value for the interpretation of tax regulations.

6. The principle of equality vis-à-vis public burdens

6.01. The generally accepted principle in current constitutions that the law cannot make distinctions between persons affords different possibilities of application in the tax field.

Latin American tax law recognizes, without exception, equality as regards the physical and moral conditions of the human being (race, religion, political ideas, etc.) and also as regards economic aspects, based on the rule of equal treatment to those who find themselves in similar conditions. Latin American jurisprudence abounds in decisions of this type, declaring the unconstitutionality of laws that disregard the principle; a power which is generally attributed to the Supreme Courts of Justice.

6.2. In the second place, however, there is the problem posed by some constitutions, as to the use of taxation as an instrument for achieving non-fiscal objectives of general, economic and social interest, which objectives may be contrary to the traditional concept of equality. The 1978 Constitution of Ecuador which incorporates provisions of the Constitution of 1945 and the Tax Code of 1975, acknowledges the principle of equality, although it attributes to tax regulations the function of promoting investment and savings and their use in national development and in securing a just distribution of income and wealth among all the inhabitants of the country. The Constitution of Venezuela provides that "the tax system will ensure the just distribution of burdens according to the taxpayer's economic capacity, in response to the principle of progressivity, the protection of the national economy and the improvement of the people's standard of living".

For these objectives of social justice and economic development to be achieved through taxation necessarily results in discriminatory treatment, generally as a result of exemptions or surtaxes. This situation is opposed to the principle of equality, especially in the countries that lack constitutional regulations on such objectives, and thus has deserved the attention of the doctrine and influenced legislation in the past years.

The Latin American legislation affords numerous examples of tax incentives to economic development, generally by way of exemptions. This legislative trend, which sometimes has resulted in excesses, has been subjected to review from the technical as well as legal viewpoints. On this point, it is worth recalling the IFA Congress (Jerusalem, 1976) and, particularly with respect to Latin America, the 7th Symposium on Tax Law (Caracas, 1975). At the latter meeting it was considered that "tax incentives are against the principle of equality conceived as the principle of taxpaying capacity; and in such cases, one must harmonize it with other values of public interest expressly or implicitly stated in the Constitution".

Mexico's case deserves special attention. Its Constitution provides that there will be no tax exemptions. The interpretation of this regulation has led to doctrinary discrepancies, where the prevailing opinion appears to be that the constitutional prohibition only refers to the rights and privileges that result in inequalities among individual citizens, but not to those that stimulate economic development. The decisions of the Supreme Court coincide with this interpretation, i.e. that the constitution refers to those cases where a specific person is treated favorably, thus establishing a privilege in his favor, but not when such favorable treatment affects a whole category of persons under laws of a general nature.

The restriction of exemptions for the purposes of economic incentives or social justice, recommended by the recent neo-liberal theory, had an effect on the legislation of the countries that followed the policy of non-interference from the Government in the market economy. For this reason, the present panorama in Latin American affords heterogeneous solutions, subject to new revisions resulting from the economic and fiscal crises being experienced by the countries of the region.

In this regard, it is interesting to quote Article 261 of the Constitution of Panama, which provides that "The law will ensure, to the extent possible, according to the need to collect public funds and to protect national production, that any tax will burden the taxpayer in direct proportion to his taxpaying capacity."

6.3. From a strictly legal viewpoint, tax exemptions as an intrument for non-tax purposes are strongly supported. This support is based on the view that the principle of equality can adequately be coordinated with that of social welfare and economic progress, aspects of essential importance to the developing countries.

6.4. Lastly, as regards the application of the law by the administration in specific cases, the principle of equality is supported by both the doctrine and the law, and thus the administrative rulings that create differences not permitted by the law are considered illegal and, therefore, revocable.

III. INTERNATIONAL TAX LAW

7. Doctrinal and legislative overview

A standard position is generally attributed to the Latin American countries, characterized by a radical defense of the principle of territoriality or source, totally opposed to that of nationality or residence maintained by the developed countries.

A detailed analysis of that position results in differentiating several trends that in the past years have become embodied in doctrinal statements, treaty models, internal legislation and international treaties supporting one or the other of the aforementioned principles or which make adjustments to them.

The doctrine shows an obvious evolution, through which some excesses of the original concept of the principle of territoriality are eliminated. The model treaties, in particular the Andean Pact, are fully within the traditional concept; internal legislation shows the most varied solutions; the treaties signed between the countries of the region abide by the traditional principle, while those signed with the developed countries include concessions that allow for locating them within the scheme of the OECD Model.

7.1. *The doctrine*

Since the meeting of the Fiscal Committee of the League of Nations, held in Mexico in 1943, the Latin American doctrine has carefully studied this matter through two private organizations of a high technical level, the Inter-American Bar Association (IABA), obviously influenced by North American lawyers, and the Latin American Tax Law Institute (ILADT), both upholders of the territoriality principle, although the former allows certain concessions, while the latter makes some adjustments.

In several statements, the IABA emphasized the acceptance of tax sparing provisions and suggested several solutions for making it effective. In 1969, it approved a model treaty of an eclectic nature with some deviations from the traditional doctrine, among them the acceptance of the concept of permanent establishment, which is so strongly opposed by the doctrine.

The ILADT at several meetings (Montevideo, 1956; Buenos Aires, 1964; Punta del Este, 1970 and Caracas, 1975) initially upheld the principle of territoriality as the exclusive criterion of tax jurisdiction, and also strongly recommended the introduction of a tax sparing provision; this is undoubtedly of great practical importance due to the permanent and general conflict between the incentive policies used by the Latin American countries and the United States' refusal to accept this clause. The interest aroused by this topic called for holding, within the framework of the 22nd IFA Congress (Montevideo, 1968) a high level international Seminar, where representatives from every continent were present.

At the last two ILADT meetings, the doctrine was improved to the extent that at the meeting held in Caracas, important problems were discussed relating to dividends, interest, royalties, technical assistance fees and personal services.

In the first place, the Caracas Recommendation supports the previous recommendations on the adoption of the principle of territoriality *as a priority basis for taxation,* "not only because of its intrinsic virtues, but because it is the most appropriate one for promoting the transfer of capital and technology for economic and social development purposes at the international level". With respect to the specific problems mentioned, it precisely determines, in our opinion, where such income should be located and confirms the "net income" taxation criterion, which had not been expressly acknowledged until then and which offered opposite solutions in the Latin American models and internal legislation. As regards incentives, it promotes coordinated actions with the developed countries, through treaties whose objectives may be not only to avoid double taxation but to stimulate the transfer of capital and technology. With respect to the tax treatment of related companies (parent and subsidiary companies or branches) it was opposed to certain legislation and jurisprudence. In principle the general rules for independent corporations should be applied, complemented with legal controls, limitations and requirements that avoid results which are to the detriment of the treasuries, particularly those in Latin America (as has been evidenced from experience). The complete English version may be read in 30 *Bulletin for International Fiscal Documentation* (1976) at 16.

7.2. *Discrepancies with the UN Group of Experts*

The guidelines approved by the UN group are not in harmony with the position previously summarized and much less, as is obvious, with the Latin American Models. From a general standpoint, the Guidelines avoid the most crucial issues (mainly interest and royalties) that directly affect the transfer of capital and technology, which was the main objective sought through ECOSOC on establishing the Group in 1967. On the other hand, use of the OECD Model as a basis for its work (which was precisely what they were attempting to modify) led to the adoption of solutions which are strongly opposed in Latin America. A typical example is the adoption of the concept of "permanent establishment" with slight variations from the regulations determined by the OECD. Thus the criticisms arising in Latin America as a result of its initial action and Guidelines are not surprising. Among them one must highlight the unanimous statement of the already mentioned ILADT Meeting held in Punta del Este in which it was stated that the Group of Experts was fulfilling "neither the letter nor the spirit which motivated its creation". Likewise, one should recall the observations made at the Seminar of the 33rd IFA Congress (Copenhagen, 1979).

7.3. *The position of governments and international government organizations*

These organizations have made different pronouncements.

The countries of the *Andean Pact*, with their internationally known Model, advocate in the most radical manner the solution of the traditional national source concept. The Model upholds the principle of territoriality as the exclusive criterion of tax jurisdiction. On certain occasions it deviates for reasons of purely fiscal interest, as in the case of remunerations for technical assistance. This position is practically inapplicable in dealings with the developed countries, as stated by one of the authors at the Seminar of the 28th IFA Congress (Mexico 1974). The most obvious evidence of such inapplicability is the Treaty signed by Ecuador and Germany in 1977, which is based on the German and OECD models, even though Ecuador is a member of the Andean Pact.

A similar consideration applies to the so-called *ALALC Guidelines,* which are actually the basis for a draft treaty Model except that they offer several optional solutions with regard to such important aspects as interest, royalties and personal remunerations, all of them within the principle of territoriality.

The same guidelines are followed by the Model prepared by the members of the *Cuenca del Plata* in 1978 (Argentina, Bolivia, Brazil, Paraguay and Uruguay) which substantially follows the ALALC guidelines, even as regards the non-definition of essential aspects. However, this Model provides for significant adjustments for associated companies, inspired by the OECD Model Convention.

The work of the Inter-American Center of Tax Administrators (CIAT) has been oriented toward a technical study carried out by Latin American, European and North American experts through its "Technical Conferences", "Assemblies" and Courses for Administrators which have been widely published internationally (including in the *Bulletin for International Fiscal Documentation*). We consider this work to be a valuable contribution for clarifying such problems, mainly as to procedures for combating international tax evasion.

7.4. *Internal legislation*

With regard to the application of different criteria in fiscal legislation, *Table 1* represents a summary of the taxation criteria used in taxing income by 18 Latin American countries in relation to income tax.

Even though all the countries appearing in *Table 1* apply a global income tax, 2 of them (Ecuador and the Dominican Republic) use a mixed system of schedular and global taxes, i.e. based on the coexistence of specific taxes imposed on certain categories or income schedules, with a complementary tax applied on the overall net income of individual taxpayers (see 11.1.2.2.). On the other hand, of the remaining 16 countries, 2 of them only apply such tax partially. In fact, Paraguay does not tax income obtained from agricultural production and personal compensation in general, while Uruguay only taxes income resulting from industrial and commercial activities and the like and income originating from real estate and technical assistance received by individuals from abroad.

The criteria used are in all cases based on legal and regulatory provisions in force, without taking into account special incentives, nor the interpretations that may be derived from administrative and judicial decisions.

From *Table 1,* it may be concluded that all countries generally use the source criterion to tax the income of non-domiciled taxpayers.

Table 1
Criteria used in taxing income

Country	Individuals Domiciled or residing in the country	Individuals Domiciled or residing abroad	Corporations Domiciled or residing in the country	Corporations Domiciled or residing abroad
Argentina	S	S	S	S
Bolivia	S	S	S	S
Brazil	W	S	S	S
Colombia	W	S	W	S
Costa Rica	S	S	S	S
Chile	W	S	W	S
Ecuador	S	S	S	S
El Salvador	W	S	S	S
Guatemala	S	S	S	S
Honduras	W	S	W	S
Mexico	W	S	W	S
Nicaragua	S	S	S	S
Panama	S	S	S	S
Paraguay	S	S	S	S
Peru	W	S	W	S
Dominican Republic	S	S	S	S
Uruguay	S	S	S	S
Venezuela	S	S	S	S

Key: W = world criterion, and S = territorial source criterion.

On the other hand, of these 18 countries, there are 11 that apply, as a basic jurisdictional principle, the territorial source criterion, for taxpayers domiciled or residing in the country (Argentina, Bolivia, Costa Rica, Ecuador, Guatemala, Nicaragua, Panama, Paraguay, Dominican Republic, Uruguay and Venezuela).

In turn, the 7 remaining countries apply the world income criterion, in a general or partial manner, as follows:

- 2 countries apply the territorial source criterion to *corporations* domiciled or created in the country and the world income criterion to *individuals* domiciled in the country (Brazil and El Salvador).
- there are 5 countries that apply the world criterion to corporations as well as individuals domiciled in the country (Colombia, Chile, Honduras, Mexico and Peru).

Table 2
Special aspects relating to the territorial-source concept observed in seven Latin American countries that use the world criterion in taxing income

Countries	Acceptance of foreign tax credit	Observations
Brazil	Yes (under reciprocity conditions)	– Foreign-source income of foreign individuals originating from dividends and interest is not taxed during the first 5 years following the change of domicile to Brazil
Colombia	Yes	– Foreign-source income of foreign individuals is not taxed during the first four years of residence in Colombia. – Income derived from technical assistance received from abroad, salaries of public officials abroad, life annuities, when the beneficiary is domiciled in the country and interest in certain cases are taxed as national income.
Chile	The Director of Internal Taxes has powers for avoiding double taxation	– Only the Chilean-source income of foreign individuals domiciled in Chile is taxed during the first three years of residence in Chile. – In the case of interest, the source is the debtor's domicile. – The salaries of public officials abroad are taxed as income of Chilean-source.
El Salvador	Yes	– The source of credit is the debtor's domicile. – In the case of income originating from industrial property and concessions, the place of registry is considered as the source. – Exempted income distributed by a corporation to its partners is also considered exempted.
Honduras		– Income originating from merchant ships flying the Honduran flag, salaries paid from Honduras, and profits from the sale of shares or securities issued by corporations established according to Honduran law are considered as national-source income.

Mexico	Yes (includes indirect credit in certain cases)	– The concept of "permanent establishment" is used to determine the Mexican-source tax of corporations constituted abroad. – The salaries of Directors abroad, income originating from the sale of shares or partnership when the issuing corporation is Mexican and dividends and earnings distributed by a corporation domiciled in the country are considered as Mexican-source income. – Presumptions are used for determining the Mexican-source in the case of income originating from the use of personal property, interest and royalties. – Mexican-source income is not taken into account when determining the amount of temporary payments to be made by individuals.
Peru	Yes	– The concept of "permanent establishment" is used for determining the Peruvian-source tax of corporations established abroad. – Salaries paid to Directors and public officials abroad are considered as Peruvian-source income. – Income from the sale of shares or participation in corporations established in the country, the interest on obligations when the issuing entity is established in the country and technical assistance rendered by individuals from abroad are considered Peruvian-source income.

Table 3
Basic legal sources that define or describe the national-source concept

Argentina	Art. 5 Act/Art. 8 Decree
Bolivia	Art. 7 Act 11153 & Art. 22 Act 11154
Colombia	Art. 14 D.L. 2053/74
Costa Rica	Art. 2 Act/Art. 2 Regulation
Chile	Arts. 10 and 11 Act
Ecuador	Arts. 10 and 11 Act/Arts. 7 and 8 Regulation
El Salvador	Art. 5 Act/Art. 6 Decree
Guatemala	Art. 1 Act/Art. 10 Decree
Honduras	Art. 9 Decree
Mexico	Arts. 144 to 161 Act
Nicaragua	Art. 2 Act
Panama	Art. 2 Regulation
Paraguay	Art. 4 Regulation
Peru	Art. 9 Act/Arts. 8 to 19 Regulation
Dominican Republic	Art. 3 Act/Art. 20 Regulation
Uruguay	Art. 3 Act
Venezuela	Arts. 1 and 4 Act

In *Table 2,* it can be seen that of the 7 countries applying the world criterion, almost all of them have provisions that imply an extension of the territorial source concept in some cases.

Table 3 describes the legal sources from which the territorial source concept is derived. The definition or description of this concept shows that almost all countries use a similar terminology inasmuch as the national source is characterized by income originating from assets economically located, placed or used in the country, as well as from acts or activities and events occurring within the limits of the national territory.

Table 4 shows the deviations from the territorial source criterion by the 11 countries applying it in a general manner.

Table 5 describes the manner in which the tax is applied in the case of international transportation, communication and insurance companies, companies distributing news and companies exhibiting and distributing films, not established in the country, as defined by the laws of the particular countries.

Table 6 summarizes the taxation criterion applied by 6 Latin American countries with a net worth tax in force.

7.5. *Tax treaties*

As regards treaties for avoiding international double taxation, the present situation may be summarized as follows:

(a) Almost all countries have limited treaties in force to eliminate double taxation of income derived from international transportation activities.

(b) As regards comprehensive treaties on income and capital taxes, Argentina, Bolivia, Brazil, Chile, Ecuador, Peru and the Dominican Republic have approved or signed such agreements as follows:

- *Argentina* has treaties in force with Sweden, Bolivia, the Federal Republic of Germany, France and Brazil. It has approved treaties with Austria and Italy (they have only to exchange documents) and has signed (pending legal ratification) treaties with Chile and the United States of America. It is currently negotiating treaties with Belgium, Canada, the United Kingdom and Romania.
- *Bolivia* has a treaty in force with Argentina.
- *Brazil* has entered into agreements with Argentina, Austria, Belgium, Denmark, Finland, France, the Federal Republic of Germany, Italy, Japan, Luxembourg, Norway, Portugal, Spain and Sweden.
- *Chile* has signed a treaty with Argentina.
- *Ecuador* signed a treaty with the Federal Republic of Germany in 1982, although the instruments of ratification have not been exchanged.
- *Peru* has a treaty in force with Sweden since 1968.
- *The Dominican Republic* has had a treaty in force with Canada since 1977.

In relation to the treaties signed by Argentina with Bolivia and Chile it may be said that these follow the guidelines of the "Andean Pact Model", which exclusively recognizes taxation in the source country. Likewise, the treaty with Brazil follows the general guidelines of the "ALALC Model", which provides for priority taxation in the source country. With respect to the treaties signed with the European countries and the United States of America, they follow in general the guidelines of the "OECD Model". That is, they use the concept of "permanent establishment" and provide for

Table 4

Special aspects of the territorial-source criterion provided in the legislation of the Latin American countries that use such criterion in a general manner

Countries	*Taxes imposed on* (1)	(2)	(3)	(4)	(5)	(6)	*Observations*	*Legislation in force in*
Argentina	X	X	X	X	X	X	– The earnings of Argentine international transportation companies and the life annuities paid by companies established in the country are considered in full Argentine-source income. Tax credit on occasional income obtained abroad is recognized.	1982
Bolivia	X	X	X				– Only for corporations in the case of column 2. – There are regulations for preventing double taxation according to the criterion of the Andean Pact Model.	1982
Costa Rica			X	X	X	X	– *The following income is considered of Costa Rican source:* – income obtained from international transportation and communication activities by companies domiciled in the country; – income obtained from the hiring in the country of services of any nature to be rendered abroad; – income obtained from the provision of news from abroad to individuals domiciled in the country; – income obtained by individuals domiciled abroad as a result of the production and commercialization in the country of films and the like; – the distribution of earnings generated in the country; – the salaries of crews of ships registered in Costa Rica; – pensions paid by entities domiciled in the country; – Permanent establishments of non-domiciled individuals existing in the country are considered as taxpayers inasmuch as they obtain taxable net income.	1982
Guatemala					X	X	– The following is considered to be Guatemalan-source income: – interest on loans negotiated abroad; – pensions received by foreign residents not devoted to profitable activities are not taxed when these are originated abroad; – dividends distributed by corporations whose income is exempted.	1983
Nicaragua						X	– The "permanent establishment" concept is used to determine the source. – Financial institutions domiciled abroad pay as tax 10% of interest received from debtors residing in Nicaragua.	1982
Panama						X	– Dividends are foreign-source if they are distributed from foreign-source income. – The following are not considered as of Panamanian source: – income originating from transactions directed from an office established in Panama that are, nevertheless, carried out or bring about results abroad. – those derived from billing operations when the merchandise is handled exclusively abroad. – the interest on loans of corporations which exclusively receive foreign-source income.	1983
Paraguay				X				
Dominican Republic	X	X			X	X		
Uruguay			X				– The Tax Code provides that the tax laws are applicable in the case of services rendered by the Government outside the country.	1982
Venezuela			X			X	– The Tax code affords the possibility of imposing taxes on activities carried out abroad and provides that in such cases the law will attempt to reconcile the effects of such provisions with the convenience of avoiding double taxation. – Taxes on interest on loans granted by financial institutions constituted abroad and not domiciled in the country.	1981

* *References:*

(1) Credit interest guaranteed with federal taxes is taxed according to the place where the assets are located.
(2) Interest on debentures or obligations is taxed if the issuing entity is established in the country.
(3) Technical assistance from abroad.
(4) Salaries of directors and councils working abroad.
(5) Remunerations for occasional activities carried out abroad.
(6) Salaries of public officials performing tasks abroad.

Table 5

Determination of source and taxable income in the case of international transportation and communication, and insurance companies, news agencies and film exhibiting and distributing companies, not constituted or domiciled in the country

Country		*Transportation and communication companies*	*Insurance companies*	*International news agencies*	*Film exhibiting and distrib. companies*
Argentina	SI	Gross amount of income derived from operations between Argentina and abroad.	Income from operations covering risks in the country.	Gross compensation	Price paid.
	TI	10% of SI (15% in the case of "containers") (absolute presumption).	Real income with deduction of expenses (absolute presumption).	10% of SI (absolute presumption).	50% of SI (absolute presumption).
Bolivia	SI	Gross amount of income derived from operations between Bolivia and abroad.	Income from operations covering risks in the country.	Gross compensation	Price paid.
	TI	2% of SI.	2% of SI.	2% of SI (absolute presumption).	15% of SI (absolute presumption).
Brazil	SI	Gross income from Brazilian source.			
	TI	20% or option for determination of it on real basis.			
Colombia	SI	Proportion of real income according to ratio of gross national income to gross total income.			Price paid.
Costa Rica	TI	SI less expenses. Administrative resolutions according to percentages of world income.			60% of SI.
Ecuador	SI	Gross income from sales in the country through permanent establishments.	Real earnings or based on coefficients determined by the Administration.		Real net earnings in the country through permanent establishments.
	TI	2% of SI.			
El Salvador	SI	Proportion of total income according to gross income.	Proportion of total income according to gross income.	Proportion of total income according to gross income.	Proportion of total income according to gross income.
	TI	SI less expenses.	SI less expenses.	SI less expenses.	SI less expenses.
Guatemala	SI	Gross amount of income between Guatemala and abroad.	Income from operations covering risks in the country.		Gross income received.
	TI	10% of SI.			80% of SI.
Honduras	SI	Amount of sales in the country.	Income from operations covering risks in the country.	Gross income.	Gross income received.
	TI	20% of SI.	10% of SI.		
Mexico	SI	Ratio of local earnings to world earnings.			
Nicaragua	SI	The amount received in the country.	Income from operations covering risks in the country.		Gross income received.
	TI	Between 5% and 10% of SI.	Between 2% and 10% according to type of insurance.		30% of SI.
Panama	SI	Gross income derived from operations between Panama and abroad and vice versa.	Real income for operations covering risks in the country.		Gross income received.
	TI	Option between 10% of SI or real income.	Real income (exempted reinsurance).		15%, 50%, or 75% of SI, as the case may be.

Country		Transportation and communication companies	Insurance companies	International news agencies	Film exhibiting and distrib.companies
Paraguay	SI	Income from contracts in the country.	Income from operations covering risks in the country.		Gross income received.
	TI	10% of SI.	10% of SI (8% in reinsurance.)		60% of SI.
Peru	SI	Income between Peru and abroad.		Gross income received.	Gross income received.
	TI	Between 1% and 5% of SI, as the case may be.		10% of SI.	20% of SI.
Dominican Republic	SI	Income derived from operations between Dom. Rep. and abroad.	Income from operations covering risks in the country.		Gross income received.
	TI	Option between 10% of SI or real income.		10% of SI.	20% of SI.
Uruguay	SI	Income derived from operations between Uruguay and abroad.	Income from operations covering risks in the country.	Gross income received.	Gross income received.
	TI	Option between 10% of SI or real income.	Option between 2% and 10% of SI according to type of insurance or real income.	Option between 10% of SI or real income.	Option between 30% of SI or real income.
Venezuela	SI	50% of gross income for operations between Venezuela and abroad and vice versa.	Income from operations covering risks in the country.	Gross income received.	Gross income received.
	TI	10% of SI.	30% of SI.	15% of SI.	25% of SI.

Notes:
SI: Determination of income from national source.
TI: Determination of taxable income.

Table 6
Taxation criterion used by Latin American countries imposing a net worth tax

Country	Criterion	Obersvations
Argentina	S	Tax on individuals and corporations in force until 1985. Determines the concept of "assets permanently located abroad".
Colombia	S	Only on individuals. Includes assets abroad when they are related to the business turnover, are in transit, or are related to contributions to foreign corporations doing business in Colombia or in the case of credits originating from the export of assets.
El Salvador	S	Applied in the case of commercial and industrial corporations (Net Worth Tax, Series A).
Nicaragua	W	Annual tax imposed on individuals and corporations.
Peru	W	Capital Stock Tax.
Uruguay	S	Tax imposed on individuals and corporations which is temporarily in force.

Key: W = world criterion, and S = territorial source criterion.

measures to avoid double taxation through the exemption in the country of domicile of income obtained in the source country or through credits for taxes paid below the maximum quotas determined in the agreement, which in certain cases exceed the real rates (matching credit). Such is the case of treaties signed by Germany, Austria and Sweden with Brazil and that of Germany with Argentina in 1978. Comments on 50 tax treaties signed by Germany, including the agreement with Brazil, appear in a recent work by Professor Klaus Vogel, from the University of Munich.

The treaties signed by Brazil with Italy and Japan and by Argentina with Sweden (1962) grant "tax sparing" in certain special situations.

8. Comments

The first aspect to be highlighted is the mixture of doctrinal, legislative and governmental solutions which hinders the establishment of a single Latin American position. There is a doctrinal position which is unquestionably accepted in scientific circles; another position is that of the governments making statements of theoretical principles, without the possibility of practical application. There is another position in other governments – mainly Argentina and Brazil – which favors the signing of treaties with developed countries on the basis of the OECD Model as regards the acceptance of a more or less broad concept of permanent establishment and the limitation of the power to tax certain income (interest and royalties, for example) but which grant some significant advantages to Latin American countries, such as the acceptance by developed countries of clauses relative to certain income exemptions (dividends) and tax sparing or credit matching, for others, such as interest and royalties.

These latter modalities justify the lack of interest by the Latin American countries in signing treaties with countries that do not accept exemptions and privileges which are adequate for facilitating the transfer of capital and technology and which is perhaps one of the main objectives pursued by developing countries when signing tax treaties.

The possibilities of a rapprochement and harmonization between the Latin American and developed countries lies, then, in the adaptation of the principle of territoriality to rational limits, as is being promoted by the Latin American doctrine and certain European doctrine and the acceptance of the principle that the treaties between developed and developing countries should be structured on different bases than those between developed countries and with the purpose not only of avoiding double taxation, and combating international tax evasion, but also of promoting economic and social development, as intended by ECOSOC when it established the Group of Experts.

IV. STRUCTURE OF THE TAXATION SYSTEMS (to 31 December 1983)

9. The evolution of tax systems

It must be pointed out that, particularly since 1960, there have been changes in the tax legislation of the Latin American countries, as a result of the trend in almost all of them, towards a more active role of fiscal and tax policy. On the other hand, the tax modifications have also originated from the increasing financial needs of the governments, stimulated by the ever-greater role which the government is playing in almost all of these countries and in the fiscal deficits resulting from economic depression and the increase of foreign debt. Under the influence of these factors significant changes in the tax structure have been made in the past 20 years, which in many cases have been called "tax reforms". In this regard we may mention the recent tax reforms in Argentina and Chile (1983 and 1984).

The relevant aspects of such changes have been:

1. During this period, a certain stability of direct taxation (especially as regards income tax) and a more dynamic evolution in indirect taxation (essentially with regard to sales tax and, particularly, value added tax) can be seen.
2. With regard to income tax, the following events may be mentioned as significant examples of its evolution in the past 20 years:
   - 2.1. The reorganization of the system in Argentina in 1974 (even the name was changed and the former tax came to be called tax on profits) and in Bolivia in 1973 and 1982.
   - 2.2. In 1979, personal tax was abolished in Uruguay, the tax remaining in force only for income from commercial and industrial activities. In Peru, individual income tax was replaced by a special tax on income, in 1982.
   - 2.3. The "nationality" criterion was eliminated in Mexico in 1980 and in Peru the "world" criterion was partially abandoned in 1981.
   - 2.4. Changes were introduced in Colombia in 1982 and 1983, in Nicaragua in 1979 and in Chile in 1984, with a view to ensuring the "transparency" of the tax and avoiding double taxation of corporations and shareholders.
   - 2.5. Attempts were made toward taxing the potential income from land, implemented in Uruguay in 1960 and in Argentina in 1973, although in this latter country it was abolished due to technical difficulties. One must note the strong support which the system has in these countries and in prestigious international meetings held on the subject in Latin America.
3. As regards net worth taxation, a weak trend toward introducing the net worth tax is observed in the legislation of Argentina, Colombia, Chile, El Salvador, Peru, Uruguay and more recently in Nicaragua. Nevertheless, as time went on, it was abolished in Chile and its elimination is announced in Argentina and Uruguay.
4. With respect to sales taxation, the introduction of the value added tax or the change to this type of taxation occurred in Colombia (1963 and 1983), Uruguay (1967 and 1972), Ecuador (1970), Bolivia (1973), Peru (1973 and 1981), Costa Rica, Argentina, Chile and Honduras (1975), Panama (1977), Nicaragua (1978), Mexico (1980), Haiti (1982), Guatemala and Dominican Republic (1983), its introduction also being hinted at in Venezuela. At present, of the Latin American countries, only El Salvador and Venezuela do not impose a general sales tax, even though the former levies a sales tax within the stamp system. Lastly, Paraguay applies a single stage type of tax.
5. Within indirect taxation, there is a trend toward the introduction of systems of specific internal taxes on production and consumption, in some cases under the name of "selective excise taxes", for example, in Argentina and Uruguay. Likewise, one may also observe the elimination or absorption of taxes collected through stamps or stamped paper in Argentina, Nicaragua, Peru and Uruguay, for example, while Colombia eliminated stamped paper in 1981.
6. An interesting aspect, mainly related to direct taxation, is the establishment and improvement of fiscal adjustment or correction systems, aimed at neutralizing the effects of inflation. This is the case in, among other countries, Argentina, Bolivia, Brazil, Colombia, Chile, Peru and Uruguay.
7. A tax area which has undergone a major development during this period is that of the revision, systematization and codification of tax legislation, which is evidenced by the approval of Tax Codes. This legislative movement began in Mexico (1936/1939) with the Fiscal Code of the Federation, followed by Panama in 1956 with its Fiscal Code and by Argentina with its provincial Fiscal Codes (starting in 1948), of which a significant forerunner is the gen-

eral law called "Procedure for the Application and Verification of Taxes". Further examples are Colombia's 1977 legislation and Nicaragua's "Common Tax Legislation" of 1962. This movement, as described in detail in 2, received a tremendous boost with the approval of the "Model Tax Code for Latin America", prepared by the Joint OAS/IDB Taxation program.

8. As regards betterment taxes, Panama approved a law on this subject in 1973 and following the work of the IDB, carried out during the late Seventies, some trend can be seen along these lines as, for example, in the approval of similar systems in Nicaragua and Peru.
9. In an important paper presented by the Mexican delegation to the CIAT Assembly held in 1981 in Mexico, it was stated that "on the subject of tax incentives, all countries use total or partial tax exemption as incentive; half of them grant specific percentages of credit against taxes, estimated on the basis of investments made by taxpayers or on the value of specific operations. Only two countries use tax deferral as an incentive. The most generalized objective of tax incentives is the promotion of the export of goods or services, followed in importance by agricultural, livestock and related activities, tourism and promotion of the establishment of industries in previously determined areas. To a lesser extent, they pursue the promotion of primary industries or activities considered of national interest, the construction of popular housing, the creation of new jobs, the exploitation of natural resources and facilities for the "maquila" industries. It is worth noting that these comments refer to a survey performed in 18 countries of the Americas.
10. The tax harmonization process in the countries of the Americas has been strong at the analysis level, especially at ALALC, the results of which were tax treaty models and studies of unquestionable value in such areas as tax codification, income, sales and excise taxes.
11. According to the presentation by the delegation of Mexico to the CIAT Assembly in 1981, only three countries of the Americas had not approved in the previous 20 years general tax amnesty, condonation, whitewashing or regularization systems. In this regard, the report mentions the case of Mexico, which limits its power to assess differences in taxes only to the last fiscal year, and conditions the collection with respect to previous fiscal years upon whether during the last fiscal year the taxpayer has not committed any serious violation.

10. Importance of direct and indirect taxation

As observed in *Table 7,* tax revenues constitute in all countries the main part of current central government revenues.

On the other hand, one observes in *Tables 8 and 9* that indirect taxation exceeds direct taxation, as a percentage of current revenues, in most of the countries of the Americas shown. In fact, only in Barbados, Trinidad and Tobago, Venezuela and Panama has direct taxation

Table 7
Tax revenues of central governments: 1970, 1975, 1978-82 (percentage of current revenues)

Country	1970	1975	1978	1979	1980	1981	1982*
Argentina	88.1	84.3	74.4	68.4	75.1	76.3	78.5
Barbados	86.3	88.8	88.6	89.8	87.8	88.6	88.6
Bolivia	92.9	92.9	92.1	88.8	85.7	98.4	98.6
Brazil	90.6	88.3	81.5	80.1	72.0	75.9	73.9
Colombia	96.4	97.5	97.5	98.2	98.0	98.1	98.1
Costa Rica	95.6	95.0	95.4	95.0	89.0	93.0	94.6
Chile	93.9	97.9	94.4	95.9	92.8	86.3	87.0
Dominican Republic	89.7	91.0	92.8	90.0	80.1	80.9	88.0
Ecuador	94.0	96.5	96.9	95.5	93.7	94.3	94.0
El Salvador	90.4	93.5	94.6	95.5	95.0	89.4	89.4
Guatemala	90.0	91.3	93.7	93.1	90.8	87.0	84.1
Haiti	60.1	78.4	86.0	88.0	92.8	86.2	88.9
Honduras	89.7	81.4	92.5	90.4	91.9	93.7	92.9
Jamaica	90.7	95.2	97.1	97.0	96.6	95.2	93.9
México	90.3	94.4	95.7	96.1	95.5	94.9	94.2
Nicaragua	85.3	86.1	82.8	78.6	86.2	81.4	79.6
Panama	80.5	76.4	90.7	75.3	64.8	70.4	61.2
Paraguay	89.1	88.7	88.4	89.0	89.4	88.6	87.3
Peru	86.2	91.3	92.8	89.8	92.4	90.7	90.6
Surinam	79.9	90.9	90.5	86.7	85.0	81.2	72.2
Trinidad and Tobago	83.4	83.8	78.8	79.6	82.6	83.2	84.3
Uruguay	91.6	95.2	90.3	89.0	92.1	85.2	87.7
Venezuela	63.6	71.6	70.2	76.1	81.6	86.7	77.4

* Estimated.

Source: "Progreso Económico y Social de América Latina.–Informe 1983". – Banco Interamericano de Desarrollo. – Washington D.C., 1984. – ("Social and Economic Development in Latin America. – 1983 Report" – Interamerican Development Bank. – Washington D.C., 1984).

come to exceed indirect taxation. This situation is explained, in the case of the first three countries, as a result of the importance of taxation and fees applicable to the exploitation and sale of mineral products, in particular petroleum.

From *Tables 10 and 11,* it can be stated that within direct taxation, income taxes stand out because of their importance, especially in Barbados, Brazil, Honduras, Jamaica, Mexico, Panama, Dominican Republic, Surinam, Trinidad and Tobago and Venezuela. Real estate taxes which include those applied on capital, as percentages of current revenues, are particularly significant in Barbados and Uruguay.

With respect to indirect taxation, *Tables 12 and 13* show the importance of sales and production taxes on the one hand and of taxes on foreign trade on the other (as percentages of current revenues). Apparently, general sales and excise taxes have acquired great importance in almost all countries, especially in Argentina, Bolivia, Chile, Guatemala, Nicaragua and Uruguay. Taxes on foreign trade are also universally important, especially in Bolivia, Colombia, Costa Rica, Ecuador, Haiti and Honduras.

In an important paper entitled "Present Tax Policy and Systems; Orientations toward Reform", presented by Claudino Pita at the High Level Technical Conference sponsored by the Ministry of Economy and Finance of Spain and CIAT, held in March 1984 in Madrid, it was stated that "in eighteen of the twenty-five developing countries of the Americas which were examined, the collection of the same type of taxes has been maintained, though it is worth noting that in some cases, the relative participation varied significantly even in the case of the same taxes. Such is the case of Argentina where the percentage of participation of sales and production taxes increased 65%, in Chile the participation of that same type of production and sales taxes increased 37%, in Uruguay the participation of these taxes also increased 41.6%, and in Trinidad and Tobago, where the collection of income tax increased its percentage of participation by 76.6%. In the other countries, the changes in percentage were not as significant." Further, "only in one case the change occurred from taxation on production and sales to income taxation. That was in the case of federal taxes in Brazil, which actually shows in 1981 participation percentages that are almost identical as regards income tax (37.3%) and taxes on production and sales (37.2%). In Colombia, there was a shift from income tax to taxes on foreign trade; while in Costa Rica and Honduras the shift was from taxes on production and sales toward taxes on foreign trade. In the case of Bolivia, the opposite happened, taxes on foreign trade relinquished first place as a revenue earner to taxes on production and sales."

11. Summary of the structure of main taxes

11.1. *Income tax*

1. A tax on income is totally or partially applied in the 19 countries of the Americas indicated in *Table 14.* Its relative importance with regard to total current revenues collected by the governments may be seen from *Table 10.*
2. As regards the income taxes applied in the 19 countries shown in *Table 14,* the following may be pointed out:
   2.1. There are 16 countries which apply a global income tax system on taxpayers (basically on individuals and corporations). Of these, there are 2 countries that apply the tax in a restricted manner, since Paraguay leaves out most of the income derived from personal work, dividends and other income originating from agriculture and livestock activities. On the other hand, Peru does not apply the income tax on personal remunerations which pay a monthly substitute tax called the "single tax on remunerations for personal services", with a progressive rate scale ranging between 2% and 10%.
   2.2. There are two countries (Ecuador and the Dominican Republic) that maintain a mixed system, by taxing certain categories of income and imposing a supplementary tax at progressive rates on total individual income. Chile, which also had this system, modified it in January 1984, by eliminating the 2nd category schedular tax on income originating from work and providing that the 1st category tax of 10% applicable to capital and corporate income

Table 8
Direct taxes of central governments: 1970, 1975, 1978-82 (percentage of current revenues)

Country	1970	1975	1978	1979	1980	1981	1982*
Argentina	33.8	9.2	17.0	15.2	21.8	7.6	10.4
Barbados	43.2	46.0	47.5	44.5	41.5	43.6	45.6
Bolivia	17.1	10.8	14.5	15.8	11.5	18.4	21.9
Brazil	24.1	25.5	27.3	29.5	25.2	28.3	29.3
Colombia	48.3	45.9	36.3	32.7	31.2	25.9	25.4
Costa Rica	23.7	22.1	26.0	25.8	20.3	20.9	23.7
Chile	23.5	28.9	22.4	24.5	23.7	22.5	n.a.
Dominican Republic	22.4	22.3	22.3	22.4	23.5	23.1	27.5
Ecuador	15.8	11.7	11.9	12.2	9.8	15.0	15.0
El Salvador	22.1	25.1	26.9	21.3	28.3	26.1	26.9
Guatemala	15.0	19.1	15.4	14.6	13.5	14.7	13.8
Haiti	10.5	15.6	17.0	17.3	15.9	21.0	20.8
Honduras	25.0	25.5	23.5	24.1	31.1	25.1	26.8
Jamaica	40.9	33.2	28.0	30.3	41.5	36.4	40.3
México	39.7	38.4	44.5	42.8	37.0	35.4	29.6
Nicaragua	20.9	22.1	23.0	18.3	17.6	18.4	18.0
Panama	38.8	38.5	32.8	35.9	32.6	38.1	33.0
Paraguay	15.4	18.7	19.6	19.4	21.9	26.1	26.8
Peru	33.8	31.9	19.8	20.6	27.5	28.7	23.4
Surinam	38.1	16.3	27.3	27.6	29.5	25.4	23.2
Trinidad and Tobago	43.5	71.3	64.6	67.0	71.8	72.0	71.9
Uruguay	13.8	12.7	17.9	15.7	20.6	16.6	17.1
Venezuela	48.3	63.9	59.5	66.1	71.9	79.1	66.5

* Estimated.
n.a.: not available.

Source: "Progreso Económico y Social de América Latina.–Informe 1983". – Banco Interamericano de Desarrollo. – Washington D.C., 1984. – ("Social and Economic Development in Latin America. – 1983 Report" – Interamerican Development Bank. – Washington D.C., 1984).

Table 9
Indirect taxes of central governments: 1970, 1975, 1978-82 (percentage of current revenues)

Country	1970	1975	1978	1979	1980	1981	1982*
Argentina	54.2	75.1	57.4	53.2	53.3	68.7	68.1
Barbados	43.2	42.8	41.1	45.4	46.3	45.0	43.0
Bolivia	75.9	82.1	77.6	73.1	74.2	80.0	76.7
Brazil	66.5	62.7	54.2	50.6	46.9	47.6	44.6
Colombia	48.1	51.6	61.2	65.6	66.8	72.2	72.6
Costa Rica	72.0	72.9	69.4	69.2	68.7	72.2	70.9
Chile	70.4	69.0	72.1	71.4	69.1	63.8	n.a.
Dominican Republic	67.4	68.7	70.5	67.7	56.6	57.8	60.5
Ecuador	78.2	84.8	85.0	83.3	83.9	79.3	79.0
El Salvador	68.4	68.4	67.7	74.2	66.8	63.2	62.5
Guatemala	75.0	72.2	78.3	78.5	77.3	72.2	70.2
Haiti	49.5	62.7	69.0	70.7	76.9	65.2	68.1
Honduras	64.6	55.9	69.0	66.3	60.8	68.6	66.1
Jamaica	49.8	62.0	69.1	66.7	55.0	58.8	53.6
México	50.6	56.0	51.2	53.3	58.5	59.5	64.6
Nicaragua	64.4	64.0	59.8	60.4	68.6	62.9	61.6
Panama	41.8	37.8	42.2	39.4	32.2	32.3	28.2
Paraguay	73.7	70.0	68.8	69.6	67.5	62.5	60.6
Peru	52.4	59.5	73.0	69.5	64.8	70.0	67.2
Surinam	41.7	74.6	63.2	59.2	55.5	55.7	49.0
Trinidad and Tobago	39.9	12.6	14.2	12.6	10.8	11.2	12.4
Uruguay	77.8	82.5	72.4	73.4	71.4	68.6	70.6
Venezuela	15.3	7.7	10.7	10.0	9.6	7.6	11.0

* Estimated.
n.a.: not available.

Source: "Progreso Económico y Social de América Latina.–Informe 1983". – Banco Interamericano de Desarrollo. – Washington D.C., 1984. – ("Social and Economic Development in Latin America. – 1983 Report" – Interamerican Development Bank. – Washington D.C., 1984).

"may be charged to global or additional taxes" which shareholders must pay on income received by them, exclusively.

2.3. Uruguay does not impose income tax on individuals, unless they carry out commercial and industrial activities as an enterprise (joint use of capital and labor), in which case the profits are taxed at a 30% flat rate ("tax on income of industry and commerce"). In other words, income derived exclusively from capital or labor is tax exempt, leading to the exceptional result that interest is not subject to taxes, whether the interest is paid in Uruguay, or transferred abroad. Agricultural activities, on the other hand, are subject to a special progressive tax applied to total presumptive income originating from such activities and obtained by each individual taxpayer. This tax is estimated on the basis of the amount of potential income from real estate, according to expected production in a system of normal economic exploitation. On the other hand, personal remuneration is subjected to a special tax, charged to the employee (rates of 1% and 2%, depending on their amount) and to the employer (2%) which is applied to gross income.

2.4. Of the 16 countries that apply only the global system, all (except Honduras) use different rates to tax individuals and corporations. Honduras applies a single progressive rate scale to both types of taxpayers.

2.5. While the global tax is levied in all countries at progressive rates, corporate income tax is imposed in 9 countries (including Uruguay).

2.6. The maximum marginal rate of the global tax applied to individuals is 70% in the Dominican Republic and 65% in Peru. The fixed rate of tax on corporations ranges between 30% and 49%, although in Venezuela it ranges between 60% and 67%.
The maximum marginal rate in the case of progressive tax rates on corporations is 55% in Mexico and 56.1% in Peru.

2.7. Only two countries apply the "tax transparency" system with regard to corporate and dividend taxes: Chile, which allows a total credit, and Colombia, which allows a limited credit. On the other hand, there are 8 countries that apply a double tax system with a credit and 6 countries that apply the traditional system, taxing corporations and imposing a final withholding tax on dividends distributed to beneficiaries domiciled in the country. Lastly, there is one country that applies a double rate system (El Salvador) and another (Ecuador) that applies an additional tax on non-distributed earnings.

2.8. Several countries have introduced adjustment

Table 10
Income taxes of central governments: 1970, 1975, 1978-82 (percentage of current revenues)

Country	1970	1975	1978	1979	1980	1981	1982*
Argentina	17.7	8.9	15.1	13.2	18.6	6.3	7.7
Barbados	37.4	41.7	43.3	39.4	36.6	37.8	38.4
Bolivia	15.0	9.5	13.7	14.9	10.9	18.1	21.5
Brazil	24.1	25.5	27.3	29.5	25.2	28.3	29.3
Colombia	45.4	45.2	36.2	32.5	31.0	25.9	25.3
Costa Rica	18.2	21.4	24.4	24.5	19.0	19.9	22.8
Chile	19.4	23.8	18.5	21.6	23.3	22.4	n.a.
Dominican Republic	19.1	19.9	19.2	19.6	21.1	20.7	24.3
Ecuador	15.8	11.7	11.9	12.2	9.8	15.0	15.0
El Salvador	13.6	18.9	18.7	14.2	20.7	19.7	20.8
Guatemala	11.3	16.6	14.1	13.7	12.7	13.9	13.0
Haiti	7.0	12.1	13.4	13.8	12.7	17.7	17.7
Honduras	23.9	24.5	22.7	23.4	30.3	24.2	25.8
Jamaica	40.2	29.7	25.7	27.9	39.4	34.5	36.4
México	38.2	37.2	43.4	41.7	36.2	34.6	28.9
Nicaragua	9.4	13.1	15.4	10.0	8.3	11.3	10.9
Panama	34.0	34.3	27.7	28.3	26.2	31.0	27.0
Paraguay	9.0	13.1	14.7	14.9	17.3	18.9	19.3
Peru	29.8	25.5	11.1	14.7	21.3	13.4	17.7
Surinam	37.3	16.2	27.2	27.4	29.3	25.2	23.1
Trinidad and Tobago	40.7	70.8	64.0	66.5	71.5	71.7	71.5
Uruguay	8.1	9.8	13.1	12.3	15.8	11.4	10.7
Venezuela	47.9	63.8	58.5	65.9	71.7	78.9	66.3

* Estimated.
n.a.: not available.

Source: "Progreso Económico y Social de América Latina.–Informe 1983". – Banco Interamericano de Desarrollo. – Washington D.C., 1984. – ("Social and Economic Development in Latin America. – 1983 Report" – Interamerican Development Bank. – Wastington D.C., 1984).

Table 11
Real estate taxes of central governments: 1970, 1975, 1978-82 (percentage of current revenues)

Country	1970	1975	1978	1979	1980	1981	1982*
Argentina	15.5	0.1	1.9	1.9	3.2	1.3	2.7
Barbados	5.8	4.4	4.2	5.0	4.9	5.9	7.2
Bolivia	2.1	1.3	0.8	0.9	0.6	0.2	0.5
Brazil	–	–	–	–	–	–	–
Colombia	1.6	0.7	0.2	0.1	0.1	0.1	0.1
Costa Rica	0.6	0.2	1.4	1.4	1.3	0.9	0.9
Chile	4.1	3.4	3.8	2.9	0.3	–	n.a.
Dominican Republic	3.3	2.3	3.1	2.7	2.4	2.4	3.2
Ecuador	–	–	–	–	–	–	–
El Salvador	8.5	4.2	6.1	5.1	5.9	5.1	4.7
Guatemala	3.1	2.3	1.2	0.9	0.7	0.7	0.7
Haiti	3.6	1.9	1.9	1.8	1.5	1.6	1.5
Honduras	1.1	1.0	0.8	0.7	0.8	0.9	1.0
Jamaica	0.7	3.4	2.3	2.4	2.1	1.9	3.9
México	–	–	–	–	–	–	–
Nicaragua	9.4	6.7	5.3	6.3	7.4	5.6	4.6
Panama	4.3	4.0	5.0	4.7	3.9	4.1	3.4
Paraguay	6.3	5.6	4.8	4.4	4.6	3.6	4.3
Peru	4.0	4.4	4.3	3.3	3.2	4.0	3.6
Surinam	0.9	0.1	0.1	0.2	0.2	0.2	0.2
Trinidad and Tobago	2.0	0.4	0.5	0.3	0.2	0.2	0.2
Uruguay	5.7	2.9	4.8	3.3	4.8	5.1	6.4
Venezuela	0.4	0.2	1.0	0.2	0.2	0.2	0.2

* Estimated.
n.a.: not available.
–: zero or less of 0.1%.

Source: "Progreso Económico y Social de América Latina.–Informe 1983". – Banco Interamericano de Desarrollo. – Washington D.C., 1984. – ("Social and Economic Development in Latin America. – 1983 Report" – Interamerican Development Bank. – Washington D.C., 1984).

systems to neutralize the effects of inflation on the tax (that is the case in Argentina, Bolivia, Brazil, Colombia, Chile, Ecuador, Peru and Uruguay).

2.9. Several countries have established special taxes on occasional or windfall profits (for example, Colombia, Chile and Venezuela).

2.10. Several countries have established systems for applying the tax on real or presumptive bases in certain cases (for example, Brazil, Colombia, Haiti, Mexico and Uruguay). In the case of Colombia, the presumptive system is applied to a basis of net worth and gross income.

2.11. Costa Rica applies a minimum income presumption in certain cases. Other countries have established advance payments to the account of the tax, in the case of payments to professionals and to State buyers (e.g. Costa Rica and Nicaragua).

2.12. Some countries have forbidden the issue of bearer shares in some cases (Costa Rica and Uruguay).

2.13. Haiti, for example, also imposes the tax on the income of public companies.

2.14. Several countries (Costa Rica and Peru, for example) include as presumptive income the presumptive value of the house and recreational property.

2.15. Practically all countries use withholding and advance payment systems as a collection method. In some cases (Panama, for example) taxpayers who receive a single salary subject to withholding are not obliged to file an annual return.

11.2. *Net worth tax*

1. Practically all countries apply a system for taxing real estate (which has the characteristic of a national tax in El Salvador, Nicaragua and Panama).
2. Only 6 countries apply a tax on net worth (see *Table 6)*:
   2.1. Its abolition has been announced from 1985 in Argentina and Uruguay (see above).
   2.2. In the case of Argentina corporations are subject to 1.5% flat rate tax ("tax on capital"), individuals (including personal corporations and sole proprietorships) to a progressive rate ranging between 0.5% and 1.5%. In Uruguay, the tax is imposed at progressive rates ranging between 1% and 4.3% (individuals) and at a fixed 4.5% rate (shareholder capital to bearer).
   In El Salvador, the net worth tax ("Impuesto de Vialidad, Serie A"), is imposed on individuals at progressive rates ranging between 0.1% and 1.4%.
   In Colombia, the complementary individual net worth tax is progressive, ranging between 0.093% and 1.8%.

Table 12
Excise and sales taxes of central governments: 1970, 1975, 1978-82 (percentage of current revenues)

Country	*1970*	*1975*	*1978*	*1979*	*1980*	*1981*	*1982**
Argentina	32.8	38.0	42.9	42.4	39.3	46.9	44.2
Barbados	18.0	19.2	22.2	23.2	24.8	24.7	24.8
Bolivia	34.5	29.4	24.8	14.7	27.1	41.8	35.5
Brazil	59.0	48.4	42.5	38.3	28.8	28.2	32.7
Colombia	8.6	18.3	20.8	20.0	20.1	19.6	19.3
Costa Rica	40.7	41.1	40.7	38.0	39.6	32.9	31.4
Chile	43.4	47.3	61.5	64.2	62.6	54.8	n.a.
Dominican Republic	20.2	14.9	24.9	24.7	21.8	26.2	33.3
Ecuador	16.5	15.0	19.2	18.3	19.9	21.1	25.0
El Salvador	24.5	22.6	18.8	17.8	20.5	19.7	19.0
Guatemala	43.3	41.1	35.5	39.6	39.9	47.0	51.3
Haiti	10.9	12.0	9.0	10.4	10.1	11.8	13.1
Honduras	36.0	28.2	26.6	25.7	24.0	26.4	30.8
Jamaica	26.6	24.1	33.1	31.4	27.8	28.0	22.0
México	27.5	42.0	36.0	34.5	24.0	24.2	24.5
Nicaragua	36.3	43.7	42.9	44.7	45.9	46.4	44.7
Panama	14.2	14.6	12.5	22.3	18.4	18.0	15.6
Paraguay	17.1	17.0	16.8	15.9	16.4	14.7	14.7
Peru	31.2	36.7	46.1	41.2	37.2	41.3	36.4
Surinam	9.0	50.1	31.6	28.1	26.4	27.8	23.0
Trinidad and Tobago	14.3	6.3	5.7	5.1	3.9	4.3	4.8
Uruguay	40.3	69.9	58.4	53.5	52.2	53.1	56.6
Venezuela	6.1	2.0	2.6	3.0	3.2	2.8	2.9

* Estimated.
n.a.: not available.

Source: "Progreso Económico y Social de América Latina.–Informe 1983". – Banco Interamericano de Desarrollo. – Washington D.C., 1984. – ("Social and Economic Development in Latin America. – 1983 Report" – Interamerican Development Bank. – Washington D.C., 1984).

Table 13
Foreign trade taxes of central governments: 1970, 1975, 1978-82 (percentage of current revenues)

Country	*1970*	*1975*	*1978*	*1979*	*1980*	*1981*	*1982**
Argentina	20.9	31.5	11.3	8.4	11.2	15.8	16.0
Barbados	24.3	15.7	17.9	21.0	20.3	19.1	15.2
Bolivia	39.1	50.0	48.9	51.9	41.7	32.4	35.6
Brazil	7.1	10.0	6.9	6.7	7.2	6.7	5.1
Colombia	27.3	23.3	28.9	35.3	36.1	41.4	43.1
Costa Rica	29.8	30.3	27.4	29.4	26.3	37.4	38.1
Chile	27.0	21.7	8.7	5.9	5.4	6.2	n.a.
Dominican Republic	45.1	52.2	43.3	40.9	33.0	29.9	24.8
Ecuador	56.6	65.5	57.8	57.8	62.0	57.6	53.2
El Salvador	38.8	36.1	39.6	47.9	37.0	29.4	28.5
Guatemala	28.0	27.7	39.9	36.1	34.7	22.8	16.3
Haiti	36.3	47.0	52.4	51.8	58.4	43.4	42.7
Honduras	28.6	27.7	42.4	40.5	36.7	42.1	35.3
Jamaica	21.2	35.4	30.7	28.3	22.8	25.7	25.8
México	18.2	10.1	11.6	15.6	27.0	28.1	21.5
Nicaragua	28.1	20.2	16.9	15.6	22.7	16.5	16.9
Panama	23.5	19.6	15.6	14.9	11.6	12.0	10.5
Paraguay	34.2	37.6	35.0	36.2	33.0	28.1	27.6
Peru	21.3	22.8	26.9	28.3	27.6	28.7	30.8
Surinam	32.7	24.5	31.6	31.1	29.0	28.0	25.9
Trinidad and Tobago	25.0	5.8	8.1	7.2	6.6	6.7	7.2
Uruguay	20.3	10.2	12.6	19.0	18.4	15.0	13.4
Venezuela	7.8	5.0	7.1	5.9	5.4	4.3	5.1

* Estimated.
n.a.: not available.

Source: "Progreso Económico y Social de América Latina.–Informe 1983". – Banco Interamericano de Desarrollo. – Washington D.C., 1984. – ("Social and Economic Development in Latin America. – 1983 Report" – Interamerican Development Bank. – Washington D.C., 1984).

In Nicaragua, the tax is levied on individuals and corporations, at progressive rates ranging between 1% and 3%.
In Peru, the "tax on entrepreneurial net worth" is levied at progressive rates ranging between 1.5% and 2.5%.

11.3. *Sales tax*

1. *General considerations*

General sales taxation has traditionally been the basis of indirect internal taxation in the countries of the Americas. This tax has been supplemented in most cases by an extensive system of stamp taxes on documents and by specific taxes on the production and the sale of certain goods (mainly alcohol and alcoholic beverages, tobacco, cigars and cigarettes, gasoline and fuel, wines, beer and soft drinks).

The general sales tax in the Latin American countries was initially a cumulative or "cascade" type of tax (although there are examples of single stage taxes, frequently at the manufacturers' and importers' level). Nevertheless, in the mid-Sixties, Colombia and Brazil adopted the "value added tax" system and, since then, one can observe in the countries of the area a clear trend toward this form of taxation. This was emphasized in the decade of the Seventies, when 11 of them transformed or began their general sales tax system based on the "value added" type.

Table 14
Summary on income tax in Latin American countries

Country	Type of tax		Global tax rates (%)	Corporate tax rates (%)		Treatment of dividends in the case of domiciled beneficiaries				Notes
	Schedular	Global		Fixed	Progressive	Classic	Classic with credit	Credit	Double rate	
Argentina		X	7–45	33			X			1
Bolivia		X	6–42	30			X			2
Brazil		X	5–55	30			X			3
Colombia		X	5–49	40				X		4
Costa Rica		X	5–50		10–50	X				5
Chile		X	5–50	40				X		6
Ecuador	X	X	8–40	30			X			7
El Salvador		X	2.85–60		2.5–15				X	8
Guatemala		X	5–48		5–42		X			9
Haiti		X	5–50		10–50	X				10
Honduras		X	3–40		3–40	X				11
Mexico		X	5–42		3.1–55		X			12
Nicaragua		X	6–50	40			X			13
Panama		X	2.5–56		20–50	X				14
Paraguay		X	5–30		25–30					15
Peru		X	2–65		30.6–56.1		X			16
Dominican Republic	X	X	3–70		10–46	X				17
Uruguay										18
Venezuela		X	4.5–45	60/67.7	18–50	X				19

Notes:
1. No withholding is made on dividends paid to previously identified beneficiaries. With regard to dividends paid to unidentified beneficiaries, a definitive withholding of 17.5% is made.
2. There is no withholding on dividends on nominal shares; they must be included in the annual return. Dividends paid on bearer shares are subject to a definitive 30% withholding.
3. In the case of dividends on bearer shares, paid by "open corporations", there is an option for a definitive 15% withholding. In the case of dividends paid by corporations other than "open" ones, there is a definitive 25% withholding. Corporations pay tax at the basic rate of 30%, while small and medium enterprises pay 25%.
4. Personal companies pay tax at the rate of 18%.
5. Dividends paid to beneficiaries domiciled in Costa Rica are subject to a definitive 15% withholding, starting on 1 January 1984.
6. A 10% credit is allowed on the global tax to be paid by the individual entrepreneur, partner or shareholder.
7. A 20% provisional withholding is made on dividends on nominal shares and 45% on bearer shares.
8. Corporations established in the country pay, in addition to income tax, progressive taxes on capitalized earnings and on non-distributed earnings. The shareholder must include the dividends received in his individual income tax return.
9. There is a provisional 10% withholding on dividends paid to domiciled beneficiaries. No withholding is made if the corporation is exempted from income tax.
10. A definitive 15% withholding on dividends is made.
11. A definitive 10% withholding on dividends is made. In case of reserves and earnings capitalization, a 5% withholding is made.
12. A definitive 55% withholding is made on dividends paid on bearer shares, except in special cases. A 55% provisional withholding is made in the case of dividends paid on nominal shares.
13. A provisional 10% withholding is made on dividends. There are special rates for certain types of corporations.
14. A definitive 10% withholding is made on dividends.
15. No withholding is made on dividends paid to beneficiaries domiciled in the country and these must not be included in the annual income tax return.
16. A 25% provisional withholding on dividends is made. When computing personal income tax, the tax on that part of global income representing dividends shall not exceed 30%.
17. Corporations pay Third Category Tax. There is a definitive withholding (Second Category Tax) on dividends paid (8% in the case of beneficiaries domiciled in the country and 18% in the case of beneficiaries domiciled abroad).
18. Enterprises pay the "Tax on Income of Industry and Commerce" at the rate of 30%.
19. Dividends are included in personal tax return, without credit. There is a 15% credit in personal tax paid by partners of limited liability corporations and the like.

2. *Summary of present situation of general sales taxation in the Latin American countries*

Up to 31 December 1983, as can be observed in *Table 15*, of 24 countries examined, 18 (75%) applied a general tax on sales at the national or federal level.

3. *Characteristics of general sales taxation in the Latin American countries*

The situation in the 18 countries that apply a general sales tax is as follows (see Table 15):

3.1. 16 countries (88%) have a valued added type system in force. All of them apply the tax at all stages of commercial processing. Worthy of particular mention is Brazil, where VAT at the national level is applied in a coordinated fashion, only in the industrial phase, and at the state level in the remaining phases of commercialization.

3.2. 2 countries use the single stage taxation system; Paraguay applies it at the manufacturer's level and on imports, while Trinidad and Tobago levies a purchase tax at the level of wholesalers and importers, inspired by the former British purchase tax.

Of the 6 countries that do not apply a general sales tax at the national or federal level, all apply an extensive system of special taxes on production and consumption. At the end of 1983, a move had been made to introduce VAT in El Salvador.

Table 15
General sales tax in Latin-American countries

Country	Do not have general sales tax	Have in force general sales tax: VAT in all stages	Have in force general sales tax: Single stage	Observations
Argentina		X		
Bolivia		X		
Barbados	X			
Brazil		X		I.P.I. at federal level only in the first stage. I.C.M. at State level in all stages.
Colomia		X		
Costa Rica		X		
Chile		X		
Dominican Republic		X		
Ecuador		X		
El Salvador	X			
Guatemala		X		
Haiti		X		
Honduras		X		
Hamaica	X			
Mexico		X		
Netherlands Antilles	X			
Nicaragua		X		
Panama		X		
Paraguay			X	At manufacturer level.
Peru		X		
Surinam	X			
Trinidad & Tobago			X	Wholesale and import level.
Uruguay		X		
Venezuela	X			

4. *Basic characteristics of the valued added tax in the countries of the Americas*

With regard to the 16 countries that impose VAT, the following aspects may be highlighted:

4.1. In general, VAT significantly contributes to the tax and overall revenues of the national government (see *Table 12*).

4.2. All countries apply the tax through the "subtraction system", i.e. on the basis of the difference between the purchase and sales tax at the time of assessment. Input tax is credited against output tax.

4.3. All countries require the tax to be shown separately on the invoice or equivalent document, as a way of authorizing the tax credit. Although several countries *authorize* taxpayers at the retail sales stage not to differentiate the tax from the price (in Bolivia, Colombia, Costa Rica, Honduras, Panama and Uruguay), others (Argentina, Chile and Ecuador) require that the tax should not be differentiated in such cases.

4.4. In most of the countries, VAT coexists with a system of internal taxation of specific products, as a general rule applicable at the manufacturing stage, and also with a rather extensive collection system based on stamps. Nevertheless, several countries, (for example, Argentina, Brazil, Chile, Panama, Peru and Uruguay) have established a way of coordinating this latter taxation form in order to gradually absorb it into the VAT. In addition, we may mention the cases of Argentina and Uruguay where the VAT is being used to reduce employer contributions to social security.

4.5. Only Brazil and the Dominican Republic exclusively apply VAT on the transaction of goods. Bolivia, Chile and Ecuador, apply it to goods and have established a supplementary taxation system on services. Taking the foregoing into consideration, as well as the legally authorized exemptions, the tax has a very broad base, especially in Bolivia, Chile, Mexico and Uruguay. In the latter two countries, the tax is applied, almost without exceptions, even on personal services rendered outside a "dependency" relationship. In Argentina, the reforms introduced in December 1983 provided for several exemptions of staple foods.

4.6. As regards exports in general, countries have adopted the practice of taxing them at a zero rate. With respect to the tax credit, Bolivia and Chile, for example, do not allow a credit on the purchase of durable goods, while Argentina spreads it over a five-year period.

4.7. There are 9 countries that apply a single rate, ranging from 5% in Bolivia, Ecuador and Panama, to 6% in the Dominican Republic, 7% in Haiti and Guatemala, 10% in Costa Rica and Nicaragua and 16% in Peru. Brazil applies numerous differential rates at the federal level. Lastly, the remaining 9 countries use a basic or general rate and, in addition, differential rates for certain essential and luxury products. Among them, Honduras has the low-

[Continued on p. 393]

El Impuesto en el Derecho Europeo y Americano*

Por Dino Jarach

En el desempeño del cargo de adjunto del profesor P.J.A. Adriani en la organización de la Oficina Internacional de Documentación Fiscal con sede en Amsterdam y en la actividad correspondiente a los propósitos de la creación de esa institución por la Asociación Internacional de Derecho Financiero y Fiscal (IFA) desde fines de abril de 1939 hasta el 21 de diciembre de 1940, me dediqué al estudio del derecho tributario comparado.

Poco después, en el estudio del régimen tributario argentino y norteamericano, en los primeros meses de mi residencia en la Argentina, llegué al convencimiento de que podía admitirse como fruto de la comparación entre el derecho positivo europeo y el americano una divergencia notable entre los dos sistemas del derecho tributario desde el punto de vista de los procedimientos de pago y de percepción; del nacimiento de la obligación tributaria y su determinación; de la necesidad de este acto como integrante de los elementos y requisitos para la existencia de dicha obligación, y la eficacia constitutiva o declarativa de aquélla en relación con el nacimiento de ésta.[1]

Observé también que en el esquema del derecho tributario europeo se atribuía a la actividad de la administración un carácter protagónico en la recaudación tributaria, que no existía en el derecho americano en que se confiaba en el consentimiento de los impuestos por los contribuyentes a través de la representación política en el parlamento.

Por ello, he podido afirmar que el mayor número de obligaciones de impuestos de toda índole, nace y se extingue por la sola intervención de los obligados al efectuar el pago del tributo debido, sin que la administración cumpla con otro cometido que el de mantener el régimen de percepción y el contralor mediante verificación y fiscalización.

Consideré como carácter saliente del derecho tributario americano la preocupación de conformar las leyes de impuesto a los preceptos de las cartas constitucionales, en medida mucho mayor que en los países europeos.

Además de límites o connotaciones de respeto efectivo a los principios fundamentales recogidos por las cartas constitucionales, la divergencia de los dos modelos de sistemas impositivos el de tipo americano se funda, no sólo, como es obvio, sobre la diferente importancia que se reconoce al papel de la administración pública en la estructura del derecho tributario, sino también en la metodología de las dos corrientes doctrinarias para establecer la definición y el desarrollo en la vida real del fenómeno "impuesto" y sus conexiones con la actividad de la administración y de la justicia.[2]

Las dos doctrinas deberían llegar a conclusiones análogas, puesto que la doctrina europea partiendo del postulado de la actividad administrativa que abarca la financiera y – más particularmente – la tributaria, desprecia al derecho tributario material como cuerpo jurídico autónomo concebido como marco operativo de la administración, mientras que la doctrina americana, al tomar como punto de partida el tributo como recurso coercitivo del Estado, llega a la conclusión de la existencia de una obligación *ex lege* y reconoce a la administración el papel eventual y subsidiario de contralor del cumplimiento exacto de parte del contribuyente de dicha obligación.

Elegí como ejemplo de la divergencia de las dos doctrinas, un trozo del administrativista italiano Cino Vitta, quien se expresa así:

> La administración fiscal no posee poderes discrecionales y la ley determina precisamente cuándo, en cuáles casos y en cuál medida ella puede recaudar un tributo sobre la riqueza privada; y, a pesar de esto, erraría quien creyera que la autoridad fiscal actúa con la finalidad de aplicar las leyes impositivas; la realidad es diferente y la autoridad fiscal está instituida para hallar dinero para el Fisco, conformándose, sin embargo, a los preceptos que las leyes han establecido al respecto.

Aquí está admirablemente enunciada la posición de los administrativistas. La posición contraria, que yo sustento, se expresa utizando la misma enunciación, con el cambio de la proposición negativa en afirmativa y viceversa. Podría, pues, formularse así:

> la administración fiscal no posee poderes discrecionales y la ley determina precisamente cuándo, en cuáles casos y en cuál medida ella puede recaudar un tributo sobre la riqueza privada; por ello, la autoridad fiscal actúa con la finalidad de aplicar las leyes impositivas y erraría quien creyese que aquélla está instituida para hallar dinero para el Fisco, conformándose a los preceptos que las leyes han establecido al respecto.

Sostuve que la doctrina americana que parte del instituto jurídico "impuesto", asigna una prevalencia a las normas que definen los presupuestos de hecho que dan origen a la obligación tributaria al verificarse su existencia concreta como identificada con la definición abstracta por la ley.

Me parece que puede comprobarse en el derecho tributario americano, un mayor apego a los principios constitucionales que rigen la imposición.

Por ejemplo, el principio de legalidad que se define

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* En ocasión del aniversario de la fundación de la Oficina Internacional de Documentación Fiscal "para su Bulletin".

1. Este distingo se formuló por primera vez en: Dino Jarach, El Hecho Imponible, 1a. edición, Buenos Aires Editorial Jurisprudencia Argentina, 1943, página 33.

2. Además de la obra mencionada en la nota 1, véase mi obra "Curso de Derecho Tributario", 3a. edición, Buenos Aires, 1980, vol. I, página 10.

como necesidad de la ley formal y material para el nacimiento de la obligación tributaria, se apoya en forma rotunda sobre el principio que tanto los impuestos como las exenciones solo nacen validamente cuando las normas legales definen con precisión y exhaustivamente el hecho imponible.

Por el contrario, la doctrina europea predominante a diferencia de la doctrina americana no acepta que la obligación tributaria nazca inmediatamente en el momento en que se verifica el hecho imponible, por efecto de la ley, mientras se limita a decir que la obligación del impuesto debe establecerse con base en la ley.

También el principio de igualdad está respetado en la doctrina y jurisprudencia americanas – podríamos decir casi fanaticamente – mientras que la doctrina europea lo considera a menudo como expresión de anhelos sin que enerve las normas tributarias que infringen dicho principio. Es ilustrativo el conjunto de trabajos y los debates de las VII Jornadas Latinoamericanas de Derecho Tributario, que tuvieron lugar en Caracas Venezuela, 1975.[3] En esa oportunidad se discutió la posible colisión entre el principio constitucional de la igualdad y las normas inspiradas por la política de incentivos fiscales. Débese subrayar que muchos de los juristas y economistas en dichas jornadas se pronunciaron por la preminencia del principio de igualdad.

Es también materia de interés el hecho que países en que la Constitución consagra dicho principio, han ofrecido al intérprete la penosa tarea de conciliar las sentencias a menudo contradictorias, de diferentes tribunales. Como resultado, después de años – podríamos decir decenios – de controversia, se desembocó en la identificación de la igualdad con el principio de la capacidad contributiva. Por otra parte, en países como Italia, España y Venezuela en que las nuevas constituciones han consagrado el principio de la capacidad contributiva, éste constituye en la práctica la base de juicios que culminan con la identificación de igualdad y capacidad contributiva. Esto no debe sorprendernos, puesto que ya el primer postulado de Adam Smith pregonaba hace dos siglos la misma identificación.

La principal característica del Derecho Tributario Americano consiste en la prevalencia del método de recaudación por medio de la declaración del contribuyente con o sin juramento o invocación de la Patria, de la conciencia o el honor. Este sistema responde a la filosofía del impuesto como criatura del Parlamento y a la libre interpretación por parte de los ciudadanos que pueden y deben conocer la ley y adaptar a ésta su conducta y sus deberes, con independencia o, por lo menos sin necesidad, de la intervención de la administración financiera a la cual está reservado un carácter eventual y subsidiario, como ya se dijo.

Predomina en los sistemas europeos, a pesar de un cambio paulatino de las legislaciones de los principales países en la misma dirección que caracteriza la doctrina americana, el papel de creador reconocido al Ejecutivo o a la autoridad hasta llegar a no admitir el pago de los impuestos, que nacen por la ley sin un acto previo de la administración.

El sistema americano implica libertad y responsabilidad, pero no asegura la certeza del cumplimiento cabal de la obligación. El europeo, en cambio, es adecuado para este papel pero somete a los contribuyentes a la iniciativa y la interpretación del funcionario competente.

Esta comparación del derecho tributario americano con el europeo puede ser menos instructivo que la de la legislación de los impuestos que integran el sistema tributario de los países a los que se refiere la investigación comparativa. Sin embargo, creo en la eficacia de la comparación del derecho administrativo, constitucional y procesal, para construir la teoría general del derecho tributario.

3. Con referencia al problema indicado en el texto que fuera objeto de los trabajos de dichas Jornadas, puede verse: Dino Jarach, Los Incentivos Fiscales y Los Principios Constitucionales de la Imposición, en la Revista "La Información", tomo XXXII, pág. 1613-1620.

Taxation in European and American Law

By Prof. Dr. Dino Jarach (extract)

Professor Jarach, who started his career at the International Bureau of Fiscal Documentation in 1939, went in December 1940 to Argentina where he dedicated himself to the study of comparative tax law. He soon discovered that there was an important difference between European and American tax law with respect to the payment and collection of taxes; the manner in which the tax obligation is created and how it is assessed; and the necessity of such procedure as an integral part of the requirements for the existence of such obligation and its implementation in relation to its establishment. He also found that the European tax administrations played a much more important role in the collection of taxes than their American counterparts whose main task is the correct application of the collection system and checking on taxpayers. A salient characteristic of the American tax system is its preoccupation with conforming the tax law to the Constitution, which is much less the case in European countries.

Of course, this is not the only difference between the European and the American tax systems since there is also a difference in the methodology as regards the definition of "tax" as well as the development of this concept in real life and its connection with the activities of the administration and the judiciary. However, European and American thought should come to analogous conclusions although in the European conception the point of departure is the activity of the administration, thus underestimating tax law as an autonomous juridical system, whereas in the American concept tax is a means of coercion of the State, thus reaching the conclusion that there is a legal obligation per se and that the administration may be granted a secondary authority to check whether the taxpayers have met their obligations.

Prof. Jarach feels that in American tax law there is a greater affinity with constitutional principles than is the case in European tax law. In America the thought prevails that the tax obligation directly arises by operation of the law at the moment that the taxable event occurs which is an idea generally rejected in Europe where one limits oneself to stating that the obligation must be based on the law.

Prof. Jarach further points out that the equality principle is much more respected in America than in Europe. As illustration he mentions the 7th Jornadas Latinoamericanas de Derecho Tributario (1975) where the conflict between the constitutional right of equal treatment and the granting of tax incentives was discussed. The equality principle is in the end to be identified with the principle that everybody should pay tax in conformity with his taxable capacity, a principle already formulated by Adam Smith.

The main characteristic of American tax law is that taxes are self-assessed through returns submitted by the taxpayers. This system reflects the basic idea that taxes are a creation of Parliament and are subject to interpretation by the citizens who can and must know the law to which they must adjust their conduct and their obligations in an independent manner, or at least without the intervention of the administration which has – as stated before – a fortuitous and secondary character. In the European tax systems – although they gradually seem to be developing in the same direction as the American tax system – the predominant tenet is that no tax has to be paid without a preceding act of the administration. The American system implies freedom and responsibility but does not assure that taxpayers will fully meet their obligations. In Europe tax compliance has been adequately provided for but their taxpayers are subject to the initiative and the interpretation of the competent authorities.

A comparison of American and European tax law could be less instructive than a comparison of the laws concerning the individual taxes which are part of a tax system. However, Prof. Jarach believes that a comparison of administrative, constitutional and procedural law could be useful for a general theory of tax law.

Argentina's Double Taxation Agreements

By Maximo Bomchil, Jr.

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I. INTRODUCTION

Traditionally, Argentina has shown little interest in the conclusion of agreements for the avoidance of double taxation with third countries. Argentina's legislation on the taxation of income and capital is strictly based on the principle of the source: only income originating in the country and capital situated therein is subject to taxation. Consequently, any limitation to the country's power to tax such income and capital cannot be compensated by the possibility of taxing foreign income and capital pertaining to persons domiciled in Argentina.

Leaving aside the agreements concluded with third countries to avoid double taxation in the field of maritime and air transportation,[1] until 1978 Argentina had signed only two comprehensive conventions to avoid double taxation of income and capital: with Sweden in 1963[2] and with West Germany in 1968.[3] In both cases the Contracting Parties accepted Argentina's point of view with regard to the taxation of dividends, interest and royalties, which were the three subjects of most concern to Argentina.

However, a clear change in this policy has taken place since 1978, following a general trend of the government towards the opening of the economy and the promotion of foreign investment to assist the development of the country. That year a double taxation agreement was concluded with West Germany,[4] which replaced the prior agreement terminated by Argentina in 1973, and since then agreements have been concluded with France,[5] Austria,[6] Bolivia,[7] Brazil[8] and Italy.[9] In addition to these agreements, which are in force right now, double taxation agreements have been concluded with Chile and the U.S.A. but their ratification is still pending. Negotiations were initiated with several other countries such as Belgium, Canada, Colombia, Spain, Finland and the Netherlands, among others.

Whether this policy will be continued in the future is, at the very least, doubtful. The new administration which took over last December has not made clear what its position will be. We understand that this position will probably be conditioned by the support which Argentina will receive from each third country involved with respect to solving other crucial problems which the country is facing, such as the refinancing of its foreign debt and its balance of trade deficits.

This article will analyze briefly the basic principles of the double taxation agreements concluded with Austria, France, Germany and Italy. These conventions follow the terminology and form of the 1977 OECD Model Convention for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital (model convention) very closely, but several changes were introduced to allow Argentina to continue the taxation of income generated and capital situated in the country.

1. Since 1946 Argentina has signed such agreements with many countries, including Colombia, Canada, Denmark, Finland, Spain, the U.S.A., etc.
2. Decree Law 12,821 of 21 November 1962. This agreement has been in force since 1 January 1963.
3. Law 17,249 of 1967. This agreement was terminated by Argentina on 1 January 1974.
4. Law 22,025 of 3 July 1979, in force since 25 November 1979. This agreement replaces that of 1967 which was terminated by Argentina in 1973 (see footnote 3).
5. Law 22,357 dated 19 December 1980, in force since 1 March 1981.
6. Law 22,589 dated 18 May 1982, in force since 18 November 1982.
7. Law 21,780 dated 14 April 1978, in force since 4 June 1979.
8. Law 22,675 dated 12 November 1982. This agreement entered into force on 7 December 1982.
9. Law 22,747 dated 21 February 1983.

II. GENERAL PROVISIONS

1. Taxes covered

In Argentina, the taxes covered by the double taxation agreements are (i) the income tax, (ii) the capital gains tax, (iii) the capital tax on enterprises and (iv) the net worth tax on individuals.

The conventions are not applicable to the special tax on additional profits and excess capital repatriation created by the Foreign Investment Law.[10]

2. Definitions

The general definitions and definitions of the terms "resident" and "permanent establishment" are similar to those in the model convention except – with regard to this last term – the following: (i) the maintenance of a fixed place of business for the purpose of purchasing goods or merchandise is considered a permanent establishment in the double taxation agreements with Germany, France and Italy, and (ii) a building site, construction or installation project will constitute a permanent establishment if it lasts more than 6 months (double taxation agreements with France, West Germany and Austria) or 9 months (Italy).

III. INCOME TAX

The basic principle of Argentine income tax is that only income from Argentine sources is taxed in Argentina, that is to say, only income originating in that country through capital or equipment situated therein or economically used therein. Individuals resident in Argentina are subject to income tax on their net income at progressive rates of 7% to 45%. There is a non-taxable minimum of about 15,000 new pesos. Share companies and limited liability partnerships are subject to a flat 33% income tax rate. When these companies or partnerships pay dividends or profits to individuals resident in the country, no further taxes are applicable, but when the dividends or profits are paid to foreign beneficiaries, a further 17.5% withholding tax applies. Branches and other permanent establishments in Argentina owned by foreign companies or individuals are subject to a 45% income tax. Foreign beneficiaries, that is to say, companies or individuals not resident in Argentina, are subject to a 45% income tax withholding on their net Argentine-source income. However, royalties for the transfer of technology are subject to an 18% withholding tax and interest on foreign loans to an 11.25% withholding tax.

These rates have been increased by 20% by an emergency income tax introduced in August 1983 which is applicable to individuals for the fiscal year ending 1983, and to companies, partnerships and branches for accounting years closed on or before 31 July 1984 and for withholding taxes levied at source until 28 September 1984.

3. Income from immovable property

The double taxation agreements copy Article 6 of the model convention, i.e. income derived from immovable property, including agriculture and forestry, *may be taxed in the country where the property is situated.* The convention with Austria stipulates that such income may be taxed in that country *exclusively.*

4. Business profits

Basically, the principle is the one established by Article 7 of the model convention. The profits of an enterprise of a contracting party can be taxed only by that state unless the enterprise has a permanent establishment in the other state, in which case *the income of such permanent establishment may be taxed by the other state.* In the Austrian convention, a permanent establishment may be taxed *only* in the country where it is situated.

However, certain differences exist: the double taxation agreement with Italy provides that insurance premiums paid by a resident of Argentina to a resident of Italy, under insurance policies covering risks located in Argentina, are subject to taxation in Argentina even if the Italian company does not have a permanent establishment in Argentina. The Austrian convention requires as a condition for taxation in Argentina that the premiums are paid through or the risks insured by a representative in Argentina.

The double taxation agreements concluded with West Germany, France and Italy provide that the total aggregated income tax attributable in Argentina to a permanent establishment may not exceed the rate applicable to companies resident in Argentina increased by 15%. Consequently the income tax of such permanent establishments in Argentina is 43.05% (33% income tax on companies plus 15% on the amount remaining after deduction of the income tax). As stated above, permanent establishments of enterprises resident in countries which do not have double taxation agreements with Argentina are subject to a 45% tax.

5. Maritime and air transport

The same rules are applicable as those established by Article 8 of the model convention.

6. Dividends

Dividends paid by a company domiciled in Argentina to a resident in the other state *may be taxed in that other state, but such dividends can also be taxed in Argentina* at a rate which may not exceed 15% of the gross amount of the dividends. The convention with Austria provides that such dividends are taxble *only* where the company is resident.

Note that dividends paid to shareholders resident in countries with which Argentina does not have a double taxation agreement are subject to a 17.5% withholding tax.

10. Law 21,382 of 26 August 1976.

7. Interest

Generally, in Argentina interest paid on foreign loans is subject to an 11.25% withholding tax. However, interest paid on loans entered into for financing the importation of movable goods subject to depreciation is tax exempt. Commissions earned by foreign banks, management fees, agency fees, etc., are not subject to tax in Argentina because they are considered foreign-source income.

The double taxation agreements provide that interest is *taxable both in Argentina and in the country where the creditor is domiciled,* but the withholding tax in Argentina may not exceed 20% in the case of the conventions with Italy and France and 15% in the convention with Germany except, in this latter case, if the loan has been granted by a bank or for the financing of public works. In this case the withholding tax is 10%. In the Austrian convention, interest is *taxable only in the country in which it originated* and at a maximum rate of 12.5%.

8. Royalties

Royalties originating in the transfer of technology or for the use of know-how, patents, trade marks and models or designs are subject to an 18% income withholding tax in Argentina if the agreements comply with the provisions of the Transfer of Technology Law[11] and have been registered at the appropriate state agency. Otherwise they shall be subject to a 45% withholding tax.

In the double taxation agreements, the term "royalties" is broadly defined as in Section 2 of Article 12 of the model convention, i.e. it includes consideration paid for the use of a copyright of literary, artistic or scientific works, industrial rights such as patents, trade marks, designs or models and know-how. Certain agreements, as those concluded with France and Italy, include in the definition of "royalties" the consideration paid for study or research work of a scientific or technical nature related to industrial, commercial or administrative methods or procedures, i.e. is generally designated as "technical assistance".

The double taxation agreements provide that royalties are taxable *both in the state where they originate as well as in the state where the beneficiary is resident,* except the Austrian convention which provides that the royalties will *only be taxable in the country in which they originate.* These provisions represent major differences with the model convention, especially in the agreements with France and Italy in which the technical assistance is considered as generating "royalties".

The withholding tax in the country in which the royalties originate is limited to 15% in the conventions concluded with Germany and Austria, while it may not exceed 18% in the agreements with France and Italy.

9. Personal services

As far as personal services are concerned (dependent and independent, directors' fees, remunerations of artists and athletes, pensions, government services and students), the double taxation agreements contain similar provisions to the model convention.

IV. CAPITAL GAINS TAX

The double taxation agreements follow the principles laid down in Article 13 of the model convention very closely. However, the double taxation agreement with Austria states that capital gains are *exclusively* taxable in the country where the immovable or movable goods sold are situated.

Basically, in Argentina only capital gains originating from the sale of real estate and participations in unlimited liability partnerships are subject to capital gains tax. The rate is 15% and it is applicable to the difference between the purchase price adjusted by inflation and the sales price.

V. CAPITAL TAX

Once more, the double taxation agreements follow the provisions of Article 22 of the model convention, as far as the taxation of capital represented by immovable property, movable property forming part of the business property of a permanent establishment and ships and aircraft is concerned. The first two may be taxed in the country where the capital is situated, while ships and aircraft are taxed in the country of effective management of the enterprise. All other elements of capital may be taxed according to the legislation in force in each contracting state.

The net worth of individuals is taxed in Argentina at a progressive rate from 0.5% to 1.5%. Only immovable and movable goods physically situated in the country are subject to the tax. Companies and business enterprises are subject to a flat 1.5% capital tax, also applicable to immovable and movable goods situated in Argentina. In every case, liabilities are deducted for determining the taxable net worth or capital.

VI. METHODS FOR ELIMINATION OF DOUBLE TAXATION

All the double taxation agreements contain provisions for the avoidance of double taxation in cases in which both contracting parties may tax the same income or capital. Such provisions differ substantially from one double taxation agreement to another.

(a) *Austria.* Follows the exemption method. When a resident in one contracting state receives income or has capital which is taxable only in the other state, the state of residence shall exempt such income or capital. As explained above, this is the case with all income and capital under the Austrian convention which is taxable only in one state.

(b) *Germany.* Two methods are followed: certain income which is taxable in Argentina shall be excluded from the taxable basis for calculation of the income tax in Germany, while other income taxed in Argentina shall generate a tax credit in Germany. Such tax credit shall be 20% for dividends and royalties paid to German residents and 15% for interest.

11. Law 22,426 of 12 March 1981.

(c) *France.* The method for avoiding double taxation is similar to that in the German convention. Certain income items taxable in Argentina are exempt in France while other income items give a right to a tax credit, as for example royalties (tax credit 20%) and interest (15%).

(d) *Italy.* Taxes paid in Argentina give a right to a tax credit in Italy. The tax credit is 20% for interest and royalties and 15% for dividends.

All the double taxation agreements provide that Argentina shall not tax income originating nor capital situated in the other country. This does not modify Argentina's internal legislation which, as explained above, follows the principle of source-taxation practically without exception.

VII. CONCLUSION

The double taxation agreements concluded by Argentina in the last years evidence the country's willingness to create a proper atmosphere for foreign investments and other trans-border transactions. The agreements follow the model convention closely, permitting, however, Argentina to tax income originating and capital situated in the country to a certain degree. It is at least doubtful whether such policy will continue in the future on a general basis. Most probably it will be limited to individuals and companies resident in countries which support Argentina in the refinancing of its foreign indebtedness and allow importation of Argentine agricultural products and other merchandise.

BRAZIL:

The Supplementary Income Tax on the Remittance of Dividends Abroad Amended

By Aleksas Juocys

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On 20 December 1983, the President of Brazil signed several decree-laws, which were subsequently published in the Official Gazette of the Federal Executive of 21 December 1983, among which Decree-Law 2,073 figures prominently. This Decree-Law altered Law 4,131 of 3 September 1962, which regulates the investment of foreign capital in Brazil and the remittances of money abroad.

The alteration concerns the assessment of the Supplementary Income Tax – ISR, which taxed "the total net profits and dividends actually remitted to individuals or legal entities resident or with head office abroad, whenever the average remittances over a 3-year period as from 1963 exceed 12% of the capital and reinvestments registered" at the Central Bank of Brazil.[1] The rates applicable to any such excess amount are:

- excess between 12 and 15% – 40%
- excess between 15 and 25% – 50%
- excess above 25% – 60%

(Art. 43(1) of Law 4,131)

Beginning on 1 January 1984, ISR, pursuant to Decree-Law 2,073, is now levied on "the total net profits and dividends with reference to foreign currency investments that are *distributed* to individuals or legal entities, resident or with head office abroad, whenever the *average distributions* over a 3-year period ending as from 1984 exceed 12% of the capital and reinvestments registered" at the Central Bank of Brazil.

In this way, the ISR that used to be levied at the time of the actual remittance of the net profits and dividends is now levied when the net profits and dividends are distributed. ISR is calculated for each 3-year period closed at the end of each calendar year, with the 2 previous years always being computed. Thus, on 31 December 1983, one 3-year period ended (1981, 1982 and 1983) and ISR should be paid on any excess remittances of profits and dividends on or before 15 January 1984.

With the advent of Decree-Law 2,073, a new 3-year cycle will begin for determination of distributions and calculation of ISR. If any ISR is owed, it will only be due on 15 January 1987. In other words, distributions of excess profits and dividends that are taxable by ISR shall now only be computed as from 1984 (1 January 1984), at which time the new wording given by Decree-Law 2,073 to Art. 43 of Law 4,131 came into effect. It is only, therefore, as from 1984 that the 3-year period in which distributions are taxable under ISR will begin; this 3-year period will end on 31 December 1986. The determination of the distributions in a 3-year period that ends after 1984 will therefore occur on 31 December 1986 (1984, 1985 and 1986). If there is an excess distribution with regard to investments and reinvestments registered at the Central Bank of Brazil, then the ISR that is owed will be paid on or before 15 January 1987. This means that

1. See for Articles on the Supplementary Income Tax on the Remittance of Dividends Abroad, 36 *Bulletin for International Fiscal Documentation* 8-9 (1982) at 395 and 37 *Bulletin for International Fiscal Documentation* 1 (1983) at 30.

foreign currency investors, resident abroad, may receive profits and dividends, even in excess of the percentage provided for investment and reinvestment registered at the Central Bank of Brazil, without any deduction or withholding by way of ISR. If any ISR is owed, it will only be paid in January 1987 and withheld from future distributions, that is, as from 1 January 1987.

In order to analyze the distributions to be computed when ascertaining any possible excess with regard to investments and reinvestments registered at the Central Bank of Brazil, one should follow the system adopted to date, since the wording given by Decree-Law 2,073 to Art. 43 of Law 4,131 is not quite clear in this respect. One should, then, understand net profits and dividends to mean those profits and dividends remaining after deduction of the income tax of the legal entity making such distribution (35% or 45%, depending on the total profits shown by the legal entity), and the income tax at source (25% rate or less if there is a treaty to avoid double taxation) on the distribution of profits and dividends to those resident abroad.

With the alteration introduced by Decree-Law 2,073, this fact – distribution of profits and dividends – will result in the assessment of two taxes: income tax at source for the resident abroad (25% rate or lower if there is a double taxation treaty) and ISR, although this latter may only be determined and calculated at the end of the calendar year in which a 3-year distribution period ends. Any distribution that allows a beneficiary resident abroad legal access to the sum to which he/it is entitled will be considered as a distribution of profits and dividends for the purposes of ISR.

Lastly, one should not confuse profits capitalized by the company itself with reinvested profits and dividends. Capitalization of profits determined by the company before any distribution is not subject to any income tax. However, profits and dividends distributed to an investor resident abroad are subject to income tax at source and also ISR if they exceed the percentage established in relation to investments and reinvestments registered at the Central Bank of Brazil. If the foreign investor should opt for reinvestment of profits and dividends distributed to it, then only income tax at source will be levied and there will be no ISR even if there is an excess with regard to the investment.

One should also keep in mind that ISR is only levied when there is a foreign currency investment. If, however, the foreign resident for some reason has investments in Brazilian currency in companies in Brazil and if profits and dividends are distributed to such resident, no ISR will be levied.

[Continued from p. 385]

est basic rate of 5%, while Argentina and Uruguay apply an 18% rate and Chile a 20% rate.

4.8. The tax is generally assessed on a monthly return. Nevertheless, Argentina, Mexico and Uruguay have established one year as the regular assessment period, and monthly payments are made as advances. Bolivia and Colombia have established a bimonthly assessment period. In case of imports, the VAT is generally collected at the customs office. Uruguay has established the possibility of requesting advance payments on imports. In Bolivia and Chile a tax "lottery system" is applied aimed at promoting the issue of vouchers to taxpayers.

4.9. In all countries, the VAT laws include provisions regarding the tax obligation. Nevertheless, in those countries having a modern Tax Code or regulations with a similar scope, many of such provisions are generally incorporated in the codified text (Argentina, Bolivia, Brazil, Costa Rica, Chile, Ecuador, Mexico, Peru and Uruguay).

IFA news

FRENCH BRANCH

On 12 June 1984 the Board of the French Branch of IFA met. Among the subjects discussed were:

Meeting with the Belgian Branch

This meeting will be held on 15 November 1984 but may be held at an earlier date, i.e. 11 October 1984. Its subject will be problems concerning small and medium-sized enterprises, in particular with respect to their legal position vis-à-vis taxation. The meeting will be held in the University of Lille – Villeneuve d'Ascq from 16.00 to 17.30.

Plenary Session of the French Branch

On 6 December 1984 the Plenary Session of the French Branch will take place in Paris. It was proposed to discuss the subject of group taxation in France and whether consolidation of income should become a normal feature of the French tax system.

EUROPEAN COMMUNITIES:

Guidelines for the Strengthening of Relations between the Community and Latin America

On 6 April 1984 the Commission of the European Communities presented a communication to the council (COM(84) 105 final) in which it offered its views on the possibilities of improving relations with Latin America.

1. For the last two years, there has been a hiatus in relations with Latin America, mainly as a result of the crisis in the South Atlantic. The most noticeable signs of this were the suspension of the "Dialogue" between the Community and the GRULA[1] and the suspension of the negotiations between the community and the Andean Pact. This hiatus has given both sides time to collect their thoughts and conduct a critical analysis of relations between Latin America and the Community.

2. Certain events suggest that it is now possible to give new impetus to these relations:

(i) the decision taken by the SELA Council[2] in September 1983 with a view to resumption of the "Dialogue";

(ii) adoption by the European Parliament in October 1983 of a resolution on relations between the Community and Latin America;

(iii) the conclusion of the negotiations for a cooperation agreement between the Community and the Andean Pact,[3] signed in December 1983;

(iv) the movement towards democracy in Latin America, with the remarkable reinstatement of a democratically elected civilian government in Argentina in November 1983.

3. All these events took place against the background of an unprecedented economic crisis in Latin America, which:

(i) seriously threatens long-term economic development;

(ii) could impair political stability.

The subcontinent has accumulated an external debt estimated at over $300,000 million, equivalent to half the debt of all the developing countries put together. Right now, as things stand, it cannot even pay the interest on its debt, not to mention repaying the debt itself. This immense problem affects the international community as a whole, the Member States and their public and private-sector financial institutions. This crisis weighs just as heavily on the development of economic relations.

This situation raises issues of an entirely new dimension for the Community's relations with Latin America, requiring renewed mutual efforts as regards dialogue and action.

The time therefore seems particularly ripe for us to take stock of relations between the Community and Latin America so that ways and means can be found to strengthen these relations.

4. An analysis of the Community's relations with Latin America reveals the following:[4]

4.1 In the sphere of trade, the conditions of access for products from Latin America have undergone a significant improvement since the sixties, owing largely to the lowering of tariffs under the GATT and the implementation of the Generalized System of Preferences (GSP). The result has been a constant expansion, in absolute terms, of exports from Latin America to the Community and the maintenance of a trade surplus in Latin America's favour. Community exports have also increased fairly steadily, but there has recently been a drastic decline owing to the restrictive measures taken in Latin America in an effort to find a way out of the economic crisis.

4.2 In the sphere of food aid and financial and technical assistance, the Community has concentrated its modest development cooperation efforts on the least-developed countries in the subcontinent, i.e. Central America and certain Andean Pact countries.

Compared with the Community's financial commitment in Africa and Asia, the impact of its aid on the economic development of Latin America as a whole is virtually non-existent, although relatively substantial in the individual recipient countries.

4.3 The other forms of cooperation, notably with the most developed countries, are still only in the early stages. Some operations have been carried out, notably under the cooperation agreements, in the spheres of industrial cooperation, research and energy.

It should also be recalled that the ECSC[5] decided to provide a loan up to US$ 600 million as a contribution towards the finance for the exploitation of an iron deposit in Brazil.

4.4 At institutional level, the Community and the Latin American countries as a whole have elaborated a procedure for a "dialogue" between the community and the GRULA, which has enabled them to analyse the problems which arise and examine possible solutions.

Economic cooperation agreements have also been concluded, at subregional level with the Andean Pact coun-

1. Group of Latin America Heads of Mission accredited to the Community.
2. *Editor's note:* SELA is the Sistema Económico Latinoamericano (Latin American Economic System). This is a permanent system of regional consultation and cooperation in economic and social progress.
3. *Editor's note:* The Andean Pact is an agreement between Bolivia, Colombia, Ecuador, Peru and Venezuela for closer cooperation.
4. This examination concerns relations at Community level. These are supplementary to the relations at Member State level, which are not included in the analysis.
5. *Editor's note:* ECSC is the European Coal and Steel Community.

tries, and at bilateral level with Mexico and Brazil. A trade agreement of limited scope has been in force since 1973 with Uruguay.

5. It should be pointed out that relations between the Community and Latin America have been marked by the Community's concern with the observance of human rights, notably following the positions adopted by the European Parliament.

6. It is appropriate to stress the point that the Community's modest efforts supplement a major network of links, both political and economic, between the Member States of the Community and most of the Latin American countries. The coming enlargement will add an extra dimension to relations between the Community and Latin America given the traditional links between Spain and Portugal and that region.

7. Despite the action taken by the Community and its Member States to strengthen its relations with the Latin American countries, they feel disappointment and frustration, even bitterness. They complain that the community has not managed to develop relations specifically modelled to suit Latin America. They regret that the Community does not attach to Latin America the importance it deserves, given the historical, cultural, political and economic links which it has with Europe.

Specifically, the Latin American countries complain about the following:

(i) the relative drop in their exports to the Community,[6] which they attribute to the special relations between the Community and the ACP States,[7] to the CAP and to the restrictive policies on textiles and steel;
(ii) their share of Community aid, which they consider too small;
(iii) Europe's criticism of, and even interference in, their internal affairs, particularly as regards their political regimes and the observance of human rights.

8. An improvement in relations with Latin America would nevertheless be in line with these countries' wishes – they are constantly seeking to diversify their political and economic relations, which are very much oriented towards the United States – and would correspond to the Community's political and economic interests. It is sufficient to point to the importance of Latin America, especially as regards its development potential and the economic areas in which the two sides complement each other.

Furthermore, as it is itself based on the rule of law, democracy and economic integration, the European Community cannot ignore the positive political developments in Latin America and would be wrong to disregard them. Having advocated and encouraged these changes over the years, it now has a duty to assume its historical responsibility to support them by all the means available to it. The resulting rapprochement between Latin America and Europe would in its turn inevitably strengthen the Community's position in the world. Nor is it possible to ignore the prospect of the accession of the countries of the Iberian Peninsula, which have made the strengthening of relations with Latin American one of the priorities of their foreign policy.

9. What could the Community do, therefore, to improve its relations with Latin America, so as to respond more fully to the aspirations of this important subcontinent and accommodate the evident interests of the Community?

10. Any Community policy must of necessity take two constraints specific to Latin America into account:

(i) the very marked diversity in the political, social and economic situations of the countries of Latin America;
(ii) the dichotomy between those countries which are still in the relatively early stages of development and those whose level of economic development resembles that of industrialized countries.

This means that the Community's approach cannot be uniform; it will have to take account of the different situations which exist in the various countries. The Community should make use above all of its development aid facilities in its dealings with the least-developed countries, and deploy other resources with the most developed. In this connection, it is also necessary to consider whether a framework agreement with Latin America as a whole would be advisable and useful.

11. From the geographical and institutional angles, relations with Latin America should be set in an overall framework at three levels:

regional: here the "renewed dialogue" between the Community and the GRULA should be developed, in line with the procedures laid down to that end, and so should relations with regional bodies and institutions of the SELA and LAIA type;

subregional and bilateral: in this context, while ensuring that the cooperation provided for under the agreements with the Andean Pact and also Mexico and Brazil is effectively implemented, the Community must examine the possibility and advisability of concluding others, notably with the Central American countries and Argentina, if its partners so wish and if the political and economic situation permits.

11.a. The Community should also consider strengthening the impact of its and the Member States' presence by better coordination of operations through more extensive exchanges of information and a more systematic examination of the ways in which the community and the Member States could act jointly as, for example, in Central America.

12. There seems to be very little scope for the Community to intensify its action in the sphere of commercial policy, at least in the short and medium term.

Nor can too much emphasis be laid on the fact that it was certainly not over-protection by the Community of industry or even agriculture which was the determining factor causing the drop or standstill in the relative share of the community market accounted for by Latin America's exports. The rise in other developing countries' exports is sufficient proof of this.

For evident reasons, the Community cannot consider

6. Latin America's share in Community imports fell from 11% in 1958 to 5.5% in 1982.

7. *Editor's note:* the ACP States are African, Caribbean and Pacific States having a special relationship with the European Communities (Convention of Lomé).

giving Latin America preferential arrangements of the type the ACP States enjoy. In any case the GSP gives it a significant degree of preferential access.

Generally speaking, the Community is also unable to absorb larger quantities of agricultural products such as cereals, meat or sugar. The current reform of the CAO could nevertheless have positive repercussions on the world markets in certain agricultural products and so indirectly produce positive effects for the Latin American countries.

The Community must also remain prepared to examine with its trade partners the possibility of increasing trade on the basis of a negotiating process of mutual interest.

On the other hand, all the Latin American countries should derive full benefit from the overall considerably free access which they have to the Community market.

The stepping up of trade promotion can help them to exploit their potential more fully, particularly by diversifying their exports in terms of products and markets.

Conversely, the restrictive import and/or export policies applied by many Latin American countries are curbing trade to an increasing degree, particularly the Community's exports. These policies also hinder the economic recovery and the development of the countries applying them. They should therefore be gradually relaxed and then abolished.

13. The Community's food aid and financial and technical assistance must continue to be concentrated on the least developed countries. The application of this policy in Latin America will therefore be confined mainly to Central America, the island of Hispaniola and certain Andean Pact countries.

Given the budgetary constraints which the Community will have to cope with over the next few years, no spectacular increase can be expected in its resources for this type of aid. The aid to Central America should nevertheless be stepped up considerably, since it is so important for these countries to achieve political, social and economic stability.

14. The Community must therefore place special emphasis on other forms of cooperation in the future. Until now Community measures to help Latin America in the sphere of trade (GSP) and development aid (financial and technical assistance, food aid) have been taken in the more general context of the implementation of Community policies *vis-à-vis* the developing countries. If other forms of cooperation of mutual interest can be implemented and strengthened, this will enable a more specific policy suited to the countries of Latin America to be developed. If one considers the countries which because of their economic situation do not meet Community criteria for receiving aid, it is seen that these account for 70% of Latin America's population and 82% of its GNP. The Community's commercial policy has barely touched these countries, apart from a few small-scale cooperation schemes.

In the Commission's opinion, the Community itself must step up its activities in the following areas:

(i) transfer resources;
(ii) industrial cooperation;
(iii) scientific cooperation;
(iv) energy cooperation;
(v) training.

14.1 *Transfer of resources*

The countries of Latin America are currently faced with serious economic problems. A number of countries which have large balance of payments deficits and considerable external debt-servicing burdens are pursuing adjustment programmes under IMF supervision, and are also resorting to refinancing through the rescheduling and consolidation of their external debt. Independently of the results obtained by the policies pursued by those countries, the burden created by the servicing of their external debt will undoubtedly continue to weigh heavily, for some years to come, on highly indebted countries. Future economic development prospects will depend on these countries' ability to secure stable net capital inflows which will be sufficient to cover their financial requirements arising from the balance of payments. As a result of the world economic crisis and the problem of international debt, net capital inflows in the region dropped from US$ 38,000 million in 1981 to US$ 4,500 million in 1983, whereas the overall external debt is over US$ 300,000 million.

These problems, which are of very wide dimensions for the Latin American countries, are being examined in institutions and under procedures established for this purpose, to which the Community as such is not a party. Furthermore, the Community institutions have no role to play in the context of bilateral relations between creditors and debtors.

The scale of Latin America's financial problems should not, however, be used as an excuse for not developing financial cooperation between the Latin American countries and the Community. Quite the contrary, the existence of serious financial problems accentuates the need for the Community to develop its financial relations with the region. Furthermore, the whole region is in the process of development and will have a constant need for financial development assistance in the long term. The Community has a role to play in this process. Through economic and financial cooperation, the Community can contribute to the sustained economic development of Latin America. The financial resources allocated by the Community to Latin America are relatively limited, however, and have mainly taken the form of development aid for the poorest countries. In view of the difficulties which the region is experiencing the time has now come for the Community to consider making a greater effort in financing development.

Given the diversity of the problems with which the Latin American countries are faced, and the differences in the economic performance, the Community's financial assistance should be specific, i.e. it should be channelled into specific sectors or projects where a major contribution can be made to particular sectors and to developing the economy.

With this in mind the Commission feels that the EIB[8] should be asked to make use of its extra-Community financing possibilities to help Latin American countries. It would recall in this respect that an extension of the

8. *Editor's note:* The EIB is the European Investment Bank.

EIB's operations in developing countries other than those of the ACP and Mediterranean areas was proposed in the Commission's "Memorandum on the Community's development policy" of 30 September 1982.

The projects to be financed in this way should be of mutual interest. They would be appraised in accordance with the Bank's usual criteria and rules, on their own merits. The Bank should pay particular attention to the possibility of co-financing, and be prepared to cooperate actively in organizing and encouraging financial consortia.

It is essential to demonstrate clearly the Community's willingness to contribute to the funding of Latin America's development. Even if the amounts were to prove relatively small, the Community would be sending out a psychologically very important signal: it would be expressing its confidence in the subcontinent's future.

14.2 *Industrial cooperation*

For over fifty years Europe's industry has woven very close links with the growth industries in Latin America, especially in Brazil.

Community industry has made a major contribution to the economic development of the subcontinent.

Private investment in Latin America has fallen off dramatically since 1981, however, as a result of the policy of austerity and the slowing down of economic growth.

It is important to stress unequivocally the degree of importance the Community still attaches to close industrial cooperation between businessmen in the two regions. The authorities should look beyond their day-to-day concerns and get this message across to industry.

This is the spirit in which the Commission will endeavour to encourage joint ventures, direct investment or technical agreements between Community and Latin American firms. It has only limited control over such cooperation, it is true, and businessmen retain their freedom of choice, but it could also help in studying and improving the legislative and administrative environment in order to facilitate industrial agreements between firms.

It is important in this respect that the Latin American countries should improve the climate of security in order to encourage foreign investment, which is often discouraged by obstructive rules and regulations.

Under the cooperation agreements (Mexico, Brazil, Andean Pact) the Commission will play its part in encouraging Community industrial circles to enter into sustained commitment in Latin America (business conferences, investment seminars, workshops, etc.).

The Commission must also consider developing cooperation in the small business sector, in which the Community has a tradition and specific capability and which fits in well with the Latin American countries' economic structure.

It should also reflect on ways and means of developing cooperation in the mining sector, a rather promising area for our relations with Latin America and one which does really present some complementary aspects.

An increase in resources is advisable for activities of this type, the budget costs of which are relatively low.

14.3 *Scientific cooperation*

In the sixties, the Community (Euratom) concluded technological agreements in the nuclear energy sphere with Argentina and Brazil, but these have generally remained a dead letter.

There have since been more modest, *ad hoc* operations, such as the financing of research in Latin America, particularly in agriculture and energy, or the inclusion of a scientific cooperation and research section in the economic and commercial cooperation agreements already concluded (Brazil, Andean Pact).

In view of the place and importance of international cooperation, notably with the developing countries, in the context of the Community's new scientific and technological strategy, and also the benefit which Europe and Latin America could reap from more extensive cooperation in science and research, it is clear that such cooperation should be organized on a more systematic basis with all the countries of the region.

Such action would have the advantage of making the following possible:

(i) the joint development of research projects, involving the active collaboration of research institutes and bodies in the Member States and in the developing countries, without prejudicing national bilateral operations, but instead supplementing and reinforcing them;

(ii) the creation of working links between the two scientific communities;

(iii) the transfer, through its own mechanisms, of European scientific know-how, amounting to "a transfer of knowledge" which will act as back-up and a preliminary for a proper "transfer of technology", an essential requirement for the development of industrial cooperation;

(iv) the implementation of guided training schemes.

Consequently, the "Science and Technology for Development" exercise, which at present is confined to agriculture, nutrition and tropical medicine, should be developed further in the light of experience; it should be stepped up and extended to the spheres in which the Community is particularly active itself (new energy sources, environment, natural resources, etc.).

14.4 *Energy cooperation*

In the sphere of energy, cooperation between Latin America and the Community has developed since the end of the seventies.

The two regions have a mutual interest in this context, since they are seeking stable energy supplies on acceptable economic terms; many of the problems of one region resemble and complement those of the other.

Joint analyses and studies are therefore particularly useful for essential problems such as the implementation of an investment policy, prices and taxation, adjustment to structural, industrial and commercial demand patterns.

The Community's experience can be of particular value to the countries of Latin America; some of them are faced with the same requirements as the Member States, notably the need to make better, efficient use of energy, in particular in industry, to encourage the replacement of oil and natural gas, to select the best available fuel for generating electricity, and to develop new and renewable sources of energy. Training, the exchange of information and experience, the transfer of know-how – in particular as regards Research, Development and Demonstration – are of the utmost importance.

Latin America has a regional body responsible for energy – OLADE. It has been cooperating with the Community in the sphere of energy since 1978-79, and this cooperation is assuming growing importance.

The amount involved (some 6 million ECU) is still very small and does not reflect the true scale of this cooperation, especially since both the Community and Latin America clearly wish to develop it in the fundamental interests of both continents.

The Community's action in this sphere must therefore be extended and strengthened in the context of relations with Latin America.

15. Of the forms of cooperation which can be developed in the context of relations with Latin America, training appears to be the most promising for establishing effective cooperation in the two sides' mutual interest. Given its level of economic and technological development and its potential in these spheres, Latin America is particularly suited and receptive to this type of cooperation. The multiplier effect which should result for the development of the countries concerned is of particular importance, as is the contribution of know-how linked with European technology.

For some time the Community has been producing training programmes for nationals of Latin American countries but the money it has so far had at its disposal has been too little to enable a structured and coordinated policy towards Latin America to be set in motion.

A special effort should be made and the available resources should be significantly increased in order to obtain an impact which measures up to the opportunities for effective cooperation between the Community and Latin America in this sphere.

16. The strengthening of relations between the Community and Latin America goes well beyond the economic sphere.

Latin America feels very close ties with Europe, since it has the same spiritual values and a civilization which is largely identical. This aspect will be accentuated with the proposed accession of Spain and Portugal.

The two regions have, however, their own historical and cultural experience. They face very different social and political problems. Consequently, they no longer understand each other fully, if at all, and they do not have as much contact as they should.

This gives rise to misunderstandings, prejudices, and a lack of mutual comprehension as witnessed, for example, by the recurring differences of opinion on human rights.

The Commission feels urgent action should be taken to reverse this tendency. It would not be in the Community's interest to see Latin America turn its back on it.

That is why the Commission proposed the founding of the Europe-Latin America Institute, to see the light of day in 1984, with the main function of establishing closer communications between the Community and Latin America, and presenting the image of Europe today to politicians, businessmen, academics, engineers, trade unionists, etc. in Latin America, and vice-versa.

That is why the Commission welcomes the more intensive contacts which the European Parliament has been seeking with political circles in Latin America (visits, parliamentary conferences, etc.).

That is also why the Commission, in conjunction with the European Parliament, set up a programme starting in 1983 for visits by journalists, administrators, academics and politicians from Latin America.

The Commission thinks it essential to see that these modest efforts are stepped up, by the Community and also by the Member States.

With this in mind, it suggests that there should be much more intensive cooperation between the Member States' embassies in Latin America. Cultural and scientific events should in future, where possible, bear a European/Community stamp.

17. To conclude, the Commission considers that the time has come for the Community and its Member States to commit themselves with determination to strengthening the Community's relations with Latin America.

It is necessary to ensure that Latin America does not feel neglected by the Community despite the individual efforts of various Member States. It is also necessary to ensure that the Community gives massive support to the reawakening of democracy in Latin America.

With a view to strengthening relations between the Community and Latin America, the Commission asks the Council to approve the guidelines put forward in this Communication. It requests in particular the Council's agreement on the need to get the Member States' Governments and the Community to work more closely together on developing an economic and financial cooperation policy tailored to the importance of relations between the Community and Latin America and reflecting clearly the Community's wish to engage in a policy of relations specifically adapted to the countries of the region.

To that end, the Commission suggests:

(i) that the EIB should be invited to apply to the countries of Latin America its facilities for funding outside the Community;

(ii) that the Community's activities should be stepped up and extended in the spheres of:
- industrial cooperation;
- scientific cooperation;
- energy cooperation;
- trade promotion;

(iii) that there should be a significant increase in training programmes for nationals of Latin American countries;

(iv) that efforts in the spheres of information and cultural exchanges should be intensified.

It intends to present precise, detailed proposals to the Council along these lines, in the light of the outcome of the discussions which will be held by the Community authorities on this Communication.

CANADA:

Transfer Pricing Issues

A Critical Discussion of the Revenue Draft Information Circular

By Nathan Boidman

This article is an edited version of a portion of a paper presented to the Thirty-fifth Canadian Tax Foundation Annual Conference which was held 28-30 November 1983 in Montreal (Canada). The focus of this article is on the Draft Information Circular which the Canadian Department of National Revenue is in the process of finalizing. In this Draft Circular the Canadian tax authorities set out their views as to the Canadian law in relation to multinationals and in particular the manner in which they intend to assess transactions involving Canadian subsidiaries of foreign-based multinational parents. The review of the situation includes the actual state of Canadian law and, in view of the Department's intention to rely upon the OECD Report on transfer pricing as well as the U.S. Section 482 Regulations, has been expanded to consider the situation in other countries.

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I. INTRODUCTION AND OVERVIEW

In many respects the question of Canadian tax issues arising in pricing of intercompany transactions is at once the most important cross-border issue and the least amenable to new informative comment or analysis.[1]

A major difficulty is that Canadian law on point is comprised of a few generally worded principles and direct case law is scarce.[2,3]

Government concern respecting major avoidance of tax through intercompany arrangements is largely left to the administrative devices of Revenue Canada in seeking to apply the general principles. In this respect the major development is an Information Circular which Revenue Canada is in the process of finalizing, which sets out its comprehensive views on fair pricing, etc.

The sudden awakening of Revenue Canada in the mid 1970s to abuses they alleged by U.S. and other foreign-based multinationals operating in Canada has evolved into a substantial imbroglio.[4]

Revenue Canada has feverishly increased its manpower and audit programs, often in cooperation with tax administrators in other countries in attempting to ferret out and assess cases of improper international intercompany arrangements.[5]

However, the situation at present is uncertain. It is still not clear what will become of Revenue Canada's high profile audit and assessment of the pharmaceutical industry, which effectively initiated the current era. It is also necessary to regard other coordinated "industry" audits. It is often difficult to determine the extent of consultation and cooperation between district office and head office in dealing with particular audit issues, etc.

The present state of uncertainty is reflected to some degree by the little known draft Information Circular concerning intercompany transactions which was distributed by Revenue Canada to certain industry groups such as the Pharmaceutical Manufacturers' Association of Canada for comment and representation. According to discussion with senior officials in Ottawa, the directive (being in the form of an Information Circular) is not considered to comprise interpretations of rules of law relevant to intercompany transactions but rather the procedures Revenue Canada is employing in carrying out settled law. However, an examination of the Circular (see below) indicates that a number of important (and perhaps challengeable) interpretations are taken in the Circular: e.g. adopting recommendations of the Organization for Economic Cooperation and Development (OECD) on multinational pricing, set out in a 1979 study,[6] and the U.S. Intercompany Regulations,[7] or stating that both subsection 69(1)(a) and 69(2) or (3) apply. More on this below.

In view of the present state of the law, it would seem that administration of the Act, audit and assessment of files, in accordance with the OECD guidelines and U.S. rules, is an important act of interpretation and requires something more than either unpublicized use thereof or statement thereof through an Information Circular. In this respect, certain other countries (Denmark, Germany and Italy) have adopted more formal (albeit administrative) regulations in seeking to embody a modified version of the OECD guidelines in its law. On the other hand, the following discussion may demonstrate the difficulty that either the courts or legislature encounter in seeking specific and comprehensive rules.

II. INTERCOMPANY PRICES FOR GOODS AND PRODUCTS

Under current law in Canada, issues in respect of proper pricing for intercompany sales of goods are either purely ones of fact, depending upon the particular circumstances under review, or issues of fact tinged by one or two difficult threshold legal issues.

A. The issue of Section 69(1)(a) v. 69(2)

Under paragraph 69(1)(a), the sale of goods between non-arm's length parties is supposed to be carried out "at

1. The law has been canvassed in several papers over the past 10 years: Tamaki, George T. and Pound, Richard W., "Intercompany Pricing: In Search of Guidelines", 22 *Canadian Tax Journal* 5 (1974) at 460; Gauthier, André, "Intercompany Charges for Services and Use of Property – Canadian Income Tax Consequences", *Report of Proceedings of the Twenty-Sixth Tax Conference,* Canadian Tax Foundation, Toronto, 1974, at 145; Ward, David A., "Pricing and International Transactions", *Report of Proceedings of the Twenty-Eighth Tax Conference,* Canadian Tax Foundation, Toronto, 1976, at 126; Peterson, James S., "International Transfer Pricing: A Canadian Perspective", *Report of the Proceedings of the Thirty-First Tax Conference,* Canadian Tax Foundation, Toronto, 1979, at 455; Robertson, John R., "A Revenue Canada Perspective on International Taxation: Transfer Pricing and Related Items", *Report of Proceedings of the Thirty-Fourth Tax Conference,* Canadian Tax Foundation, Toronto, 1982, at 773; Gourlay, James L., "Compliance Activities and Collection Procedures of Revenue Canada, Taxation", *Report of Proceedings of Thirty-Third Tax Conference,* Canadian Tax Foundation, Vancouver, 1981, at 767; Hogg, Roy D., "Intercompany Pricing: A Canadian Tax Overview", *Intertax* 6-7 (1983) at 224.
2. Section 69 of the Income Tax Act; *J. Hofert Ltd.* v. *M.N.R.,* 62 DTC 50 (T.A.B.); *Central Canada Forest Products Ltd.* v. *M.N.R.,* 52 DTC 359 (T.A.B.); *Spur Oil Ltd.* v. *The Queen,* 81 DTC 5168 (F.C.A.). See Davies, Alun G., "A Spur in the Side of Revenue Canada" in 35 *Bulletin for international fiscal documentation* (BIFD) 12 (1981) at 531.
3. In this context, one is often struck by the irony of the dramatic increase in reams of statutory rules for items of income which from a sheer revenue standpoint on a separate taxpayer basis pale in significance to the revenue dollars at stake where intercompany issues are involved: i.e. section 110.1, 125, etc.
4. This was detailed to some extent by James Gourlay, then Director-General, Compliance, in a paper at a 1982 meeting of the Canadian IFA branch as well as the papers presented by Robert J. Dart of Price Waterhouse and Marc Leduc of CN: *IFA – (Canadian Branch), Seminar on Recent Development to Counter Tax Avoidance and Evasion,* Richard De Boo Publishers (1983) – James L. Gourlay, "Developing Co-Operation Among Tax Administrators", at 1 and Robert J. Dart, Marc Leduc and Real Bedard, "Panel Discussion – Special Industry Aspects"; see also James L. Gourlay, "Address to the Pharmaceutical Manufacturers' Association of Canada, Montreal, 17 October 1980 and Robertson, supra note 1.
5. See Dart and Leduc, supra note 4, in respect of specialized audit groups, the TORT committees (Transactions with Offshore Related Taxpayers), and the Economic Intelligence Unit. See also Gourlay, supra note 1, and Robertson, supra note 1, at 774-775 and 782-786.
6. "Transfer Pricing and Multinational Enterprises", *Report of the OECD Committee on Fiscal Affairs* (1979), Organization for Economic Cooperation and Development, Paris; Messers, K., "OECD: Report on Transfer Pricing and International Enterprises", *Intertax* 8 (1979) at 288; Malherbe, Jacques, "The Report of the OECD Committee on Fiscal Affairs: Transfer Pricing and Multinational Enterprises (1979)", *Tax Management International Journal,* 1 (1980)(80-1) at 17. See also the reference to a preliminary OECD study in 1976, entitled "Guidelines for Multinational Enterprises" in Robertson's paper, supra note 1, at 775.
7. Regulations for section 482 of the Internal Revenue Code.

fair market value".[8] However, where one of the parties to the transaction is a non-resident, paragraph 69(2) or (3) is relevant requiring the price that "would have been reasonable in the circumstances had . . . [the parties] . . . been dealing at arm's length".[9]

Two questions arise. First, is there a meaningful distinction between "fair market value" for paragraph 69(1)(a) and "reasonable price" for subsection 69(2) or (3)? Second, if there is, does section 69(2) override paragraph 69(1)(c) or is the Canadian arm of a multinational enterprise faced with the burden of complying with two distinct and separate rules?

There is at least some jurisprudential support for the proposition that "fair market value" and "reasonable price" are one and the same so as to eliminate the need for further debate. In particular, in the "Christmas Tree" case (*Hofert*),[10] the Tax Appeal Board stated, in respect of "fair market value":

> [referring to a decision of the Exchequer Court in 1941 in *The King* v. *Noxzema Chemical Company of Canada, Ltd.*] . . . Maclean, J., held at page 172 that the phrase "fair price" was a commercial and not a legal term and *involved a question of fact into which many considerations might enter* . . . I discern little, if any, practical difference between "fair price" and "fair market value" . . . (emphasis added)

This would suggest that "fair market value" is not, for example, simply some incidence of a third party price, but requires a review of at least some of the particular facts in the case, more in line with the approach seemingly required by subsection 69(2).

The Department apparently is in accord with this view on this threshold question. Paragraph 6 of the Draft Information Circular states that "in theory, there is no significance between fair market value and a reasonable, arm's length price as mentioned in paragraph 5".[11] Furthermore, the Circular acknowledges that even if there is a difference, subsection 69(2) would override because "fair market value cannot be precisely determined for many products and it is more practical to apply the arm's length price" provision – that is, subsection 69(2).[12]

It may be noted, however, that the Department has somewhat cleverly left open its own interpretative and assessing process to the widest possible scope by not rejecting the possible applicability of a different standard under the fair market value of paragraph 69(1)(a),[13] although proceeding to formulate a policy which will essentially focus on determinations made under the rule in subsection 69(2) or (3).[14]

Finally, there is no authority on point in relation to section 69(1)(a) versus 69(2) although one may refer to the basic rule of statutory construction that the particular overrides the general.

B. Section 69(2): What does arm's length mean? (and the issue of "offset")

What is a reasonable price pursuant to subsection 69(2)? Is it purely a question of fact as interpreted by the taxpayer? The answer must be negative because the reference in the provision to arm's length dealing requires some reference to objective standards; at minimum it seems to contemplate the price which a reasonable person would have agreed to in the same circumstances and in order to maximize his own profit where he has a separate economic or profit interest.[15] The necessity of test-

8. Paragraph 69(1)(a):
"Where a taxpayer has acquired anything from a person with whom he was not dealing at arm's length at an amount in excess of the fair market value thereof at the time he so acquired it, he shall be deemed to have acquired it at that fair market value."
9. Subsection 69(2):
"Where a taxpayer carrying on business in Canada has paid or agreed to pay, to a non-resident person with whom he was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as 'the reasonable amount') that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income from the business, be deemed to have been the amount that was paid or is payable therefor."
Subsection 69(3):
"Where a non-resident person has paid, or agreed to pay, to a taxpayer carrying on business in Canada with whom he was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount less than the amount (in this subsection referred to as 'the reasonable amount') that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income from the business, be deemed to have been the amount that was paid or is payable therfor."
10. Supra, note 2, at 52.
11. Paragraph 5 of the Information Circular states that "under the provisions of section 69, the Department can adjust an international transfer price to reflect an arm's length price specifically 'an amount that would have been reasonable in the circumstances if (the parties) had been dealing at arm's length'". This is a reference to subsection 69(2) and (3) of the Act.
12. As noted, this would accord with *Hofert* (supra notes 2 and 10).
13. Paragraph 4 of the Circular: ". . . transfer prices . . . are subject to both paragraph 69(1)(a) and subsection 69(2) . . . ."
14. Others may not agree that "fair market value" is "in theory" the same as a reasonable price: see Dart, in his paper to the Canadian IFA branch meeting in Toronto last year, supra note 4. He constructed a particularly interesting model tending to show that a reasonable price within the meaning of subsection 69(2) may well be different from "fair market value" (where the latter is interpreted as being "orientated towards the highest price a person can obtain in an open market") and that Revenue Canada should accept section 69(2) (at 59).
15. The requirement perhaps is best captured in the German principles set out in German Guidelines in International Transfer Pricing, published by the Federal Minister of Finance on 23 February 1983 (described further below), where in paragraph 2.1.1 it is stated:
"Business dealings between related persons have to be judged for tax purposes according to whether those involved have acted in such a manner as third parties independent of each other would have done (arm's length dealing). The standard here is the relation given in a situation of free competition. *The underlying principle is the normal degree of commercial prudence shown by a sound conscientious business manager* . . . ." (emphasis aded)
and at paragraph 2.1.8:
"In determining the arm's length price, the business manager has a scope for commercial judgement in appraising the situation and in making his business decision which results from his involvement in commercial activity generally and from the state of the market. On the other hand, the management of the taxpayer enterprise has to protect the enterprise's own interests as against related persons and as against the group in its entirety in the same way as it would in dealing with unrelated third parties."
Thus in related party transactions it would apparently not be sufficient to rely on the principle enunciated by the Exchequer Court in *Olympia Floor & Wall Tile (Quebec) Ltd.* v. *M.N.R.*, 70 DTC 6085 that:
". . . the fact the businessman makes a bona fide decision to make disbursements for business reasons raises a presumption in my mind that it was 'reasonable' to make such disbursement unless facts are proved and establish that it was not 'reasonable'."

ing pricing against the separate profit interest of the Canadian unit of the multinational arises out of the arm's length requirement.

The Department takes the view that such test should apply to each transaction between multinationals and that compensation or "offset" between different transactions is not permissible. This would seem to be a pivotal issue as it limits substantially taxpayers' flexibility to structure and justify pricing arrangements. It is suggested that there is a basis for contrary opinion. In paragraph 10 of the Draft Circular:

> To the extent possible, taxpayers are encouraged to take a "clean price" approach to transfer pricing so that, for example, a product is transferred at a reasonable arm's length price for the product itself. If there are also benefits or services being transferred, as is common in the operations of a multinational group, these should be identified as separate transfers and be subject to separate evaluation and intercompany charge.

Also at paragraph 16:

> The objective is to evaluate each intercompany transfer price in terms of the amount that would have been reasonable in the circumstances if the parties had been dealing at arm's length.[16]

The question of offset gives rise, it is submitted, to an important included or ancillary legal aspect and one not addressed by the Department in the Draft Circular. In particular, it is suggested that the application of the arm's length test in subsection 69(2) does not require that one ignore the reality that the parties are in fact related and probably interdependent. This leads to the concept that the separate economic interest test, inherent in arm's length dealings, can have a *different legal significance,* where persons in fact are related to each other: *in particular in such case* there can be *two aspects* to these separate (arm's length) interests. There can be the reasonable view of the *short term* profit interest *and* that of the *longer term* profit interest.

What may seem unreasonable, when viewed in its immediate effect and separate and apart from other dealings (either of the same type or in other areas), may be quite reasonable, in relation to overall maximization of profit of the Canadian subsidiary, in the realities of the interdependence and relationship existing in a multinational group, particularly where integrated operations are involved. For example, could it not be in the separate (but long term) economic interests of the Canadian subsidiary to pay a higher price to a foreign parent for a particular product than what would be paid to a third party if such was in the context of the long term relationship that provides the Canadian subsidiary with a degree of continual and prompt access to technical innovations and new products exceeding that which would arise if the company were not part of the multinational chain? To the extent that such effects could be proven, including a showing that overall or long term profit is maximized, would not a Canadian court consider that the test of subsection 69(2) has been met?

What is important is to distinguish among the problem of proof and the question of legal requirement in subsection 69(2). It is submitted that the requirement of separate accounting for each transaction may be preferred as a matter of audit determination but is not, in fact, the proper view of the law.

Paragraph 13 of the Draft Circular also deals with this issue:

> The pertinent legislation, however, applies to each transaction between the various related parties and not to the Canadian taxable income, return on sales, return on equity or other measurement of general profitability. The Department will, to the extent practicable, analyze intercompany relationships on a transaction-by-transaction basis.

It is useful to note that the latter does seem to contemplate the possibility of having the Department accept evaluation of intercompany pricing by reference to overall or longer term measures of the economic interest of the Canadian subsidiary.

Moreover it is interesting that, although the Department states in paragraph 17 that it is basing its approach on the rules used in the U.S. under section 482 of the Internal Revenue Code and the OECD guidelines, the insistence on a transaction-by-transaction analysis does not fully accord therewith. For example, the U.S. Internal Revenue Code Regulation 1.482-2(e)(1)(iv) states:

> The methods of determining arm's length prices described in this section are stated in terms of their application to individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. *It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale.* In addition, the district director may determine or verify the arm's length price of all sales to a related entity by employing reasonable statistical sampling techniques. (emphasis added)

The OECD[17] in this respect notes at 29:

> It may be reasonable in some circumstances to analyze the transfer prices for product lines or other groupings rather than to ascertain an arm's length price for each individual's product or sale. An enterprise may find it necessary to sell some products at less than their market price or even supply them free in order to make a higher profit on its sales of products overall to the same buyer.

The OECD report also contemplates that price differentiation may arise "where the seller has rendered auxiliary services to the buyer and whether any intangible property such as patents, knowhow, goodwill or trademarks have also been transferred in connection with the sale of goods". It goes on to state:

> It is characteristic of transactions with MNE's that services or transfers of intangibles are frequently connected with the sale, and this is particularly true in some high technology industries. In such cases, remuneration for the use of intangibles or for the rendering of services may form an element of the price of goods *or* may be separately invoiced. (emphasis added)

The Business Industry and Advisory Committee to the

16. See also paragraphs 13, 66, and 67 of the Draft Information Circular in the text below.
17. Supra note 6.

OECD has expressed reservations concerning the effects of the OECD guidelines in respect of the issue of separate evaluation of each transaction. It believes the absence of specific recommendations may be misleading to tax administrators.

> BIAC believes that the various concerned tax authorities are extremely likely to use the specific method set forth in the OECD report in their review of each individual type of intercompany transaction within an MNE. The danger arises that, without specific guidance in the report, an overall consideration of the totality of relationships between the entities of the group will be ignored. In effect, tax officials will not see the forest for the trees. In such cases, although it may seem that the arm's length principle has not been observed with regard to certain of the individual intercompany transactions between two associated enterprises, conformity to the arm's length principle will nevertheless have been achieved when the picture is reviewed as a whole as, for example, by means of package deals or setoffs. In this regard, incidentally, BIAC notes that contrary to the implication in the OECD report, such arrangements are not uncommon in third party relationships. *For this reason BIAC wishes to emphasize that, in any scrutiny of transfer pricing within an MNE, initial emphasis should be placed on a judgment of the totality of overall relations within the enterprise, over a reasonable period of time, and this should be borne in mind while reviewing the separate categories or transactions within the area of transfer pricing.* (emphasis added)[18]

Finally in this respect the Draft Circular reasserts its earlier proposition at paragraphs 66 and 67 as follows:

> Unlike the corresponding legislation of some other countries, the Canadian law does not provide for reallocation of income between resident taxpayers and non-residents; instead it calls for a review of the various international transactions. There is no explicit or implicit offset in the Canadian system; a taxpayer cannot, for example, explain his high import prices by reference to favourable royalty rates.
>
> It is therefore essential to emphasize the suggestion in paragraph 10 above: all types of intra-group transfer should be identified and subject to separate evaluation. This procedure will minimize the risk that a multinational group may suffer double taxation in respect of its Canadian operations.[19]

Notwithstanding, for the reasons already mentioned above, this observer, at least, is not convinced. Furthermore, it would seem that paragraphs 10, 13, 16, 66 and 67 of the Draft are not entirely consistent with each other; this requires clarification.

C. The motive issue

The difficulties of dealing with the imprecise rules of subsection 69(2) are compounded where the Department presumes a tax avoidance motive in respect of the intercompany dealing. Therein lies a challenge for the taxpayer and Revenue Canada alike.

To some it is self-evident that the single most important contributing factor to the initiation of Revenue Canada's intercompany pricing audits of the pharmaceutical industry, and the dawn of the "modern era" of intercompany price auditing generally, was that a number of U.S.-based pharmaceutical multinationals successfully established operations in jurisdictions such as Puerto Rico, offering significant tax reductions or incentives[20] so that a *presumption of overpricing* in respect of the sale of ingredients and other raw materials to affiliated companies would be a significant concern to tax authorities in high tax jurisdictions such as Canada.

The latter, coupled with the difficulty Revenue Canada experiences[21] in carrying out audit of related foreign suppliers in attempting to determine reasonableness of pricing, results in a not unpredictable semi-paranoia in respect of the tax avoidance motivation factored into establishing intercompany pricing arrangements.[22]

This concern is indeed stated up front by the Department in its Draft Information Circular where, at paragraph 11, it notes "in assessing transfer pricing or related international pricing, the Department is in fact attacking abusive practices by which Canadian taxpayers avoid reporting their 'fair share' of the consolidated income". The Draft Circular states further at paragraph 12 that:

> This fact leads some taxpayers and their consultants to attempt a shortcut, ignoring the specific provisions of the Income Tax Act, and hurrying to a demonstration that, at the bottom line, the Canadian taxable income appears pretty reasonable.[23]

These comments are somewhat obscure. What are the shortcuts referred to? Are they the manner in which intercompany prices are determined and developed by multinationals or rather the manner in which they are explained to the Department? Why is the apparent utili-

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18. Helmers, Dag, "BIAC's Response to OECD Report on Transfer Pricing and Multinational Enterprises", *Intertax*, 8 (1980) at 286, 290.
19. See also Robertson, supra note 1, at 777.
20. See note 23 concerning Puerto Rican profits of U.S.-based pharmaceutical companies.
21. See Gourlay's papers to the Pharmaceutical Manufacturers' Association 1980 and the Canadian IFA Branch in 1982, supra note 4.
22. However, the converse proposition does not necessarily seem to hold that where the sales are being made directly from a high tax jurisdiction such as the U.S. to a Canadian subsidiary that Revenue Canada should relax its guard.
23. Revenue Canada's attitude was made plain by James Gourlay in his paper to the Canadian Branch of IFA, supra note 4, where he stated (at 5):

> ". . . multinationals have certain incentives and abilities to manipulate profits reported in different jurisdictions. It becomes quite a phenomenon the way they shift profits. It always bothers me when the ability to shift profits exists. Whether they actually do is another point, but if they have the ability, I get a little restless."

It may be noted that the Department's more particular concerns in respect of the pharmaceutical industry were stated by Mr. Gourlay in an address to the Pharmaceutical Association, supra note 4, as follows:

> "Your industry was chosen for several reasons. The larger pharmaceutical companies have increased their manufacturing operations in Ireland and Puerto Rico providing a potential for tax minimization through higher transfer prices to Canada . . . . In your industry the trend towards abusive transfer pricing may be the result of increased sourcing out of low tax areas. The Puerto Rican government, for instance, reports that the net income from the drug and pharmaceutical industry grew from $90 million in 1970 to over $1 billion in 1979 . . . ."

This theme was also evident to John Robertson (Director-General, Compliance, Revenue Canada) in his paper to the 1982 Annual Conference, supra note 1, where he said at 774:

> "The subject of transfer pricing has received increasing attention in Canada and around the world. Concern has been expressed on numerous occasions, at both the public and government levels, about possible income tax abuses arising through the manipulation of intercompany pricing. From an income tax standpoint, the incentive for 'creative' transfer pricing is apparent. We would be naive not to recognize that the international tax planner will hope to minimize income reported in Canada and other full-rate industrialized countries."

zation by taxpayers of "bottom line" analysis apparently impugned in this paragraph 12 of the Circular where, at paragraph 14, the Department specifically acknowledges that "the ultimate result of an international audit should be the taxation, in Canada, of income that is consistent both with the profitability of operations in this country and the functional contribution of the taxpayers involved"? Furthermore, the Department acknowledges at paragraph 25 of the Circular that in certain circumstances the adequacy of pricing is to be determined by:

> . . . a functional analysis of the contribution from each group member involved in producing and marketing a product. The ultimate profit for that product is apportioned among the members according to the relative value and importance of the functions performed by each. The respective transfer prices are then adjusted to produce the desired result.[24]

It is hoped that the Department will clarify its intentions arising out of the interrelationship between these and certain other areas of the Draft Information Circular. At present, it is submitted, that they would not achieve the desired effects of reducing conflicts between the Department and taxpayers in respect of intercompany pricing arrangements but rather could have the opposite effect.

Most practitioners would agree that the Department's presumption of avoidance is often justified where multinational structures involve transshipment company arrangements of the type dealt with in *Dominion Bridge,*[25] *Spur Oil*[26] and their unsuccessful criminal prosecution involving *Redpath Industries.*[27,28] However, many will argue that such presumption with respect to multinational transactions in other contexts, even where units of the group operate out of tax havens such as Puerto Rico but carry on real and viable business, is not necessarily justified. Objective assessment of the operational requirements of large multinationals, including most controls, performance evaluation, insurance requirements, and a host of other normal business exigencies, may well render price manipulation for simple purposes of reducing taxes in a country such as Canada less than a priority objective.

In this respect it should be noted that the OECD study upon which Revenue Canada relied in formulating its views states:

> On the other hand it has to be recognized that in many instances tax considerations are unlikely to be paramount where, for example, enterprises are subject to conflicting pressures from various government departments – in the home as well as the host countries – including customs authorities, exchange of price control offices and others, or where the different entities of a group face the scrutiny of minority shareholders. Divergences from non-arm's length prices will not necessarily always occur: in some multinational enterprises the members have a considerable amount of autonomy so that they can often and indeed do bargain with each other in a manner similar to that of independent entities – local managers wanting to show a good profit record for their subsidiaries may resist fixing excessive transfer prices for goods, services, rights, etc. if their local subsidiary's profit would thereby be reduced. There may be other factors tending to cause their prices to approximate to arm's length prices.[29]

Furthermore, at 28, the OECD states:

> . . . it should not be assumed that the prices actually charged within a MNE will never be arm's length prices. The transfer pricing policies of the multinational enterprises may in fact be market-orientated and, where the different entities within such groups have their own profit responsibility, they may be contracted either with an associated enterprise or with a third party with the result that there is a degree of bargaining within the group which produces a price effectively indistinguishable from an arm's length price.

There are studies which would tend to support the proposition that business factors outweigh tax avoidance objectives in determining pricing within a large multinational group. Dr. H.C. Verlage, a European economist, examined the effect of transfer pricing on economic decision making and performance of multinational enterprises and concluded that it is important to multinationals that "economically sound intercompany transfer prices and business arrangements are established". As well, he asserts that:

> . . . sophisticated use of transfer pricing in international finances is kept in good bounds by the complexity of the problem, and caused by the sheer number of financial links, instruments and effects . . .[30]

In theory, there should be no juridical effect for the Tax Department or taxpayer arising from the reason for a Department audit, whether it is inspired by presumption of avoidance or otherwise. However, inasmuch as, at this time, neither the statute nor the case law provides the Department with clear and unequivocal rules and guidelines for making its determinations, the subjective element inherent in formulating and utilizing administrative rules can easily lead to widely varying assessments, depending upon whether or not the Department starts from a presumption of sin.

It should be noted that in the U.S. the presumption of avoidance has had differing effects. The Tax Court in *Eurohost*[31] stated:

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24. As discussed below under the heading "Fourth methods", it is also clear that there is at least some use of "bottom line" analysis in the U.S.: see in particular the discussion in respect of the landmark U.S. decision in *Du Pont,* infra.

25. *Dominion Bridge co. Ltd.* v. *The Queen,* 75 DTC 5150 (F.C.T.D.).

26. Supra note 2.

27. *Regina* v. *Redpath Industries Limited and Dominion Sugar Company Limited,* 83 DTC 5117 (Quebec Ct. of Sessions).

28. With respect to transshipment companies, the Department at paragraphs 20 and 21 of the Draft Circular advises that there will be a challenge to any attempt to interpose an offshore transshipment company in existing sale or purchase arrangements by Canadian companies and third parties. In particular, the Department will "challenge the transfer prices between the taxpayer and its offshore affiliate, setting as comparables third party transactions carried out by the affiliate under existing arrangements". See recent developments in this area elsewhere: in the U.S., the 1983 decision in *Hospital Corp. of America,* 81 T.C. No. 31; in the Netherlands, the decision of the Lower Court of the Hague of 22 January 1983, published in 31 *Beslissingen in Belastingzaken/Nederlandse Belastingrechtspraak.* 8 (1983) generally quoted as BNB 1983/109 and 38 *Vakstudie Nieuws* 10 (1983) at 935; in France, decision of the Supreme Administrative Court (Conseil D'Etat of 22 December 1982) No. 27,846, *Revue de Jurisprudence Fiscale* 2 (1983) at 130.

29. Supra note 6, at 8.

30. Verlage, H.C., "Transfer Pricing by Multinational Enterprises; Issues and Developments", *Intertax* 8 (1982) at 285, 288. Dr. Verlage also states, at 286-7, that:

> "Transfer prices are an important part of the accounting system of the divisionalized enterprise. They have an influence on the profit of the two divisions involved in intercompany transactions, by the proceeds for the

> In short, section 482 does not deal with the motivation or purposes . . . but with economic reality.

This would seem to be supported by the decision in the United States in *U.S. Steel*[32] referred to below but not that in *DuPont,*[33] also referred to below.

Should Revenue Canada reconsider the tone of the Information Circular and, in particular, paragraphs 11 and 12 in light of the new German guidelines, which clearly take a far less aggressive approach to the problem, although with far more substantive content?[34]

D. Issues concerning proof

The "motive" issue is exacerbated by difficulties Revenue Canada may have in obtaining information from foreign parent companies, etc. Paragraphs 63-65 of the Circular address this issue:

> Revenue Canada only has legal access to the books and records of Canadian taxpayers and their controlled foreign affiliates. Nevertheless, in order to expedite the carrying out of an international audit, many multinational enterprises have allowed access to the records of other foreign affiliates including parent companies.
>
> The notion of extra-jurisdictional access to books and records was encouraged in a 1976 OECD report "Guidelines for Multinational Enterprises". Access to foreign cost records is particularly useful when evaluating transfer prices into Canada and cost allocations. In fact, the Department cannot accept an allocation – for example, management fees or R & D charges – without some access to the records on which the allocation was based.
>
> When denied access to foreign cost records or other critical information, the Department may attempt to obtain such data under the "exchange of information" provisions of the various tax treaties and conventions. There is growing cooperation between tax administrations around the world.

This problem was discussed by James Gourlay in his address to the Pharmaceutical Association[35] with respect to applying the "cost plus" method, discussed below, as follows:

> One problem with the cost plus method is that many companies in this industry do not disclose their cost figures. [This is reference to cost figures of the foreign parent or affiliated company.] . . . I am afraid this business of not providing cost information got me pretty upset. This has led to some confrontation. Officials, and these are senior officials from the home offices, have refused "to answer all proper questions relating to the audit" as required under paragraph 231(1)(c) of the Income Tax Act. Our policy is to be fair but firm in carrying out our duties. All proposed adjustments are discussed with them and their lawyers and we felt our proposals were valid based on the evidence before us. That we couldn't disclose our third party information didn't help, but on the other hand in these cases we were shown no factual evidence to explain the wide variance in transfer prices. I am prepared to use the powers available to me under the Income Tax Act to obtain the information necessary to complete our investigations. I will use requirements under subsection 231(3) served on the President of the Canadian company for production of relevant material from the files of the company. I will also cause an inquiry under subsection 231(7) to be conducted if need be and question the company officials to obtain under oath whatever pertinent information they might have.

Gourlay also suggested that proceeding to obtain information under double tax agreements is impracticable. He noted:

> This withholding of information is at odds with the OECD guidelines on taxation (referred to at page 23 of the OECD Guidelines for Multinational Enterprises) which would suggest that enterprises should provide us with information "including relevant information concerning their operations in other countries".

E. What is a reasonable price?

1. *The prime rule: "Comparable uncontrolled price"*

Even assuming that section 69(2) requires that the price for each separate transaction be reasonable when measured by the separate economic interest of an arm's length party, how is it to be determined and identified?

Where possible, the best objective measure would be the price actually paid or received by the Canadian unit of the multinational group in transaction with a third party where all the circumstances and facts in respect of the intercompany transaction are identical to those relating to the transaction with the third party. This is the "comparable uncontrolled price" comprising the preferred rule in the United States and other countries such as Denmark, Germany and Italy and as advocated in the OECD guidelines.

Revenue Canada will adopt the "comparable uncontrolled price" as its primary rule. Paragraph 17 of the Circular states that "Revenue Canada, Taxation follows the same basic methods of determining a reasonable, arm's length price as those specified in the U.S. (Regulations under section 482 of the Internal Revenue Code)[36] and in the 1979 OECD report 'Transfer Pricing and Multina-

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> selling division and the cost for the buying division. Therefore, when divisional management bases its decisions on divisional profit and also when, at the same time, top management reacts to divisional profit, transfer prices have an important and sometimes critical steering function."

As well he notes, at 288, that transfer pricing is important to management consultants and accounting specialists to whom "proper measurement of divisional performance is vital for the wellbeing of the divisionalised enterprise . . . ."

31. *Eurohost Inc.*, 58 T.C. 10.
32. *U.S. Steel Corp.* v. *Commissioner,* 80-1 U.S.T.C. paragraph 9307,617 F.2d 942 (2d Cir., 1980).
33. *E.I. Dupont Nemours & Co.* v. *The United States,* 79-2 U.S.T.C. paragraph 9633, 608 F.2d 445 (Ct. Cl. 1979) Crt. Den. 100 S.Ct. 1648 (1980).
34. See note 15 for the tenor of the German rules.
35. Supra note 4.
36. The U.S. rules that Revenue Canada seeks to rely upon are themselves "interpretative" regulations made in 1968 pursuant to a Secretary's authority granted under section 482 to "distribute, apportion or allocate gross income, deductions, credits or allowances . . . if he determines that such distribution . . . is necessary in order to prevent evasion of taxes or correctly reflect the income of any organizations, trades or businesses": see Professor Jane O. Burns, "Understanding the Effects of Section 482 on Intercompany Pricing", Prentice Hall, "U.S. Taxation of International Operations", paragraph 7,517 (October 1981). In the U.S. "interpretative" (as opposed to "legislative") regulations are accorded "presumptive validity" by the courts, requiring the taxpayers to show that they are manifestly incorrect in order that they be held inapplicable or ultra vires. There seems to have been some departure from the regulations in *U.S. Steel,* supra note 32 and *Du Pont,* supra note 33, as discussed below.

In Canada, the Supreme Court recently suggested that Revenue Canada interpretations may have some legal significance before a court: *Nowegijick* v.

tional Enterprises'." Paragraph 18 states "the preferred method is to compare a transfer price with a 'comparable uncontrolled price' i.e. a price established in the same market by parties who are dealing at arm's length".

An essential requirement of utilizing third party prices is that the circumstances of the sale be comparable in all respects or that differences be capable of quantification and reconciliation. The first problem is that it is rare when one can objectively determine that all of the circumstances of the sale are precisely identical. In this regard the Department states at paragraph 18:

> Application of this method tends to be restricted by the difficulty of establishing that the products involved, the market, the credit terms, the reliability of supply and other pertinent circumstances are indeed comparable.

And in paragraph 19:

> The Department acknowledges that if the "comparables" method is to be used, variations in the respective circumstances should be minor or capable of quantification on some reasonable basis.

The U.S. Regulations not only acknowledge this factor[37] but, in addition, Regulation 1.482-2(e)(1)(ii) and (iii) suggests that while use of the "comparable uncontrolled price" method is to be preferred, it is open to the U.S. taxpayer to make another showing:

> Where the standards of applying one of the three methods of pricing described in subdivision (ii) of this paragraph are met (one of which is the "comparable uncontrolled price") such method must, for the purposes of this paragraph, be utilized *unless the taxpayer can establish that, considering all of the facts and circumstances, some method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate.* (emphasis added)

The Department's Information Circular does not appear to adopt this aspect of the U.S. rules.

The difficulty inherent in utilizing comparables is stated in the introductory portion of the OECD report as follows:

> What is set out in the main body of the report must necessarily be regarded, however, as only a general guide setting out principles that may be relevant and appropriate to apply in most cases to the different circumstances arising. The report does not and cannot lay down rules that are appropriate to every aspect of every case: it is an essential feature of the problem that it is always necessary to have regard to the particular facts of each case.[38]

Furthermore, the report is quite pessimistic about any applicability of the comparable uncontrolled price method. At 13, it states:

> . . . in principle it [the comparable uncontrolled price method] is the most appropriate to use and in theory the easiest. In practice, however, it often happens that such evidence is not available or it is impracticable to collect it together or there is argument about whether the prices quoted are comparable or not. Other methods may therefore need to be used to obtain an arm's length price.

Furthermore, the OECD notes at 28:

> . . . the transactions within MNE's may not be directly comparable with those which take place between independent enterprises so that allowances have to be made in comparing their transfer prices with the prices payable between independent enterprises. For example, entities within MNE's tend to render a wide range of additional technical and management and other services to their associates in connection with the sale of goods – a feature which is less common in transactions between independent enterprises. Similarly, the production facilities of a group may be largely integrated with the consequence that the production arrangements are divided up among different group members in a way which would not be paralleled by independent enterprises. For example, these arrangements may involve long term buy and supply agreements or agreements to use combined production plants under an obligation to buy from them [joint facility arrangements].

The OECD suggests that ease of finding comparables will range from relatively easy in the case of (at 35) "an enterprise enjoying a monopoly or other dominant position in the market [which] can and often will charge uniform prices to all its unrelated customers or to all but in particular areas or uniform prices modified only by identifiable market specific factors such as import duties", to the other extreme where (at 36) "defined comparable open market prices for semi-finished goods or components may sometimes be extremely difficult and sometimes impossible [to find], since to the extent that they are specialized they are less likely to be traded on the open market".

Moreover, at 33, it is significant that the OECD states:

> It has to be recognized that an arm's length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek a reasonable approximation to it. Frequently it may be useful to take into account more than one method of reaching a satisfactory approximation to an arm's length price in light of the evidence available.

This leads to the discussion of secondary methods, which, as more fully described below (section 2), gives rise to the OECD's recommendation that there are four main broad methods available, the fourth of which is "any other method which is found to be acceptable".[39]

The Queen, 83 DTC 5041 (S.C.C.). See also *Brewster* v. *The Queen,* 76 DTC 6046 (F.C.T.D.); *British Columbia Railway Co.* v. *The Queen,* 79 DTC 5020 (F.C.T.D.); *Canadian Pacific Ltd.* v. *The Queen,* 76 DTC 6120 (F.C.T.D.); *Harman* v. *The Queen,* 79 DTC 5037 (F.C.T.D.); *Stickel* v. *M.N.R.,* 72 DTC 6178 (F.C.T.D.); *Harel* v. *The Deputy Minister of Revenue of the Province of Quebec,* [1978] 1 S.C.R. 851; and the decision of the Federal Court of Appeal in *The Queen* v. *Royal Trust Corp. of Canada,* 83 DTC 5172 at 5177.

37. Regulation 1.482-2(e)(2)(ii): "Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales . . . whether and to what extent differences in the various properties and circumstances affect price and whether differences render sales non-comparable, depends upon the particular circumstances and property involved." It appears that recent issues involving Japanese auto manufacturers turn on contentions by the Internal Revenue Service that most, if not all, differences can be identified and measured: Singer, Stuart R., and Karlin, Michael J.A., "Multinationals and New Customs Law Will have Broad Impact on Intercompany Pricing", 59 *Journal of Taxation* (1983) at 226; the article deals with *American Honda Motor Co.,* Tax Court Dock. No. 13556-78 (Tax Court petition); Technical Advice Memorandum Ltr. Rul. 8122015; and the U.S. audit of *Toyota.* The focus is on "comparability adjustment factors".

38. Supra note 6, at 10.

39. Supra note 6, at 33; this reflects the position taken by the Internal Revenue Service, as already noted, and is also adopted by the Information Circular as discussed below.

An interesting aspect of the comparable non-controlled price approach is the concern of the tax authorities that such in fact may be manipulated by taxpayers to their own advantage. Therefore, the U.S. Regulations state (Regulation 1.482-2(e)(2)(ii)):

> However, uncontrolled sales do not include sales at unrealistic prices as for example where a member makes uncontrolled sales of small quantities at a price designed to justify a non-arm's length price on a large volume of uncontrolled sales.

This is adopted in nearly identical words by the OECD report where, at 34, it is stated:

> Uncontrolled sales are, in short, those in which at least one party to the transaction is not a member of the taxpayer's affiliated group, but they would include only bona fide transactions and not sales unrepresentative of the market, for example made in a limited quantity at unrealistic prices to an unrelated buyer, for the purpose of establishing an arm's length price on a larger transaction.

However, the recent decision *U.S. Steel*[40] suggests taxpayers may have a wide latitude in selecting themselves third party transactions as a standard against which intercompany transactions may be justified. In that case U.S. Steel paid transportation charges to an offshore captive transportation company at rates established by reference to contracts the captive had with third parties which comprised only 5% of its overall volume. Seventy-three percent of the captive's business was done with the U.S. parent and was based on such price. The Internal Revenue Service challenged the validity of the "comparable" on the basis set out above (Regulation 1.484-2(e)(2)(ii)) but the taxpayer's position was upheld. In effect the taxpayers were able to do precisely what the Regulations sought to prohibit, that is create comparables to justify what would otherwise be pricing which might be difficult to sustain.

The OECD study also provides detailed guidance as to the circumstances under which prices may be considered comparable. The OECD divides the factors into those respecting "economic comparability" and those respecting "comparable market levels".

It would be most helpful if the final version of the Information Circular clarifies the degree to which these U.S. and OECD rules will be adopted, ideally, by way of detailed statement of the rules relied upon rather than the abbreviated "renvoi" featured in the draft which was circulated; this is particularly important in light of the differences in certain areas between the U.S. and OECD approaches.

James Gourlay alluded to a problem relating to proof in dealing with comparables in his paper to the Pharmaceutical Association. The Department may have developed information concerning comparables in auditing other taxpayers. However, they cannot use them in discussions with other taxpayers because of the confidentiality requirements of section 241 of the Income Tax Act.[41]

In summary, although no issue can be taken with the *principle* that the objective standard of comparable non-controlled prices should be the operative rule for section 69(2) (subject to reservations expressed in respect of the validity of assessing each transaction separately within a multinational group), the difficulties are substantial. The simplicity, objectivity and fairness of the rule seems often to be rendered inoperative when examined in the light of commercial realities affecting transactions between multinationals, particularly those with integrated operations.[42]

This leads to the discussion of "secondary methods".

2. *Secondary methods (Resale method and cost plus)*

In view of the difficulties and uncertainties relating to "comparables", the Draft Information Circular states at paragraph 22:

> Secondary methods of determining a reasonable, arm's length price are the "cost plus" and "resale" price methods. Cost plus calculations start with the transferor's cost of goods and add thereto an appropriate markup. Resale calculations work backwards from the transferee's eventual resale price, subtracting therefrom an appropriate discount or gross profit.

At paragraph 23 it states:

> The resale price method is most appropriate in those cases where no comparables are available and the purchaser adds relatively little value to the product. The greater the value of the functions performed by the purchaser, the more difficult is the determination of an appropriate resale margin for purposes of the resale price method.

This accords with the U.S. approach which, in Regulation 1.482-2(e)(1)(i)), advocates that the "resale price method" is next preferred after the comparable uncontrolled sale method but only for "a manufacturer who sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions", in the absence of which the U.S. rules next refer to the "cost plus" method which "may be appropriate . . . where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly or other processing of the product or adds significant evaluaries and of its utilization of its intangible profit prior to resale in uncontrolled transactions".

The U.S. Regulations dealing with the resale price method (Regulation 1.482-2(e)(3)) are extremely detailed with many examples and ancillary rules; similarly, Regulation 1.482-2(e)(4) dealing with the cost plus method contains a number of rules and examples to show its operation.

The OECD report also recommends secondary methods

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40. Supra note 32.
41. Supra note 4:
"This [section 24] creates major problems in pursuing meaningful discussions and negotiations. Such evidence may, of course, be produced in court under the federal court rules. This means taxpayers must resort to litigation, something all of us look upon as the last resort, in order to see the case facing them. We are renewing our attempt to obtain permission from the third parties involved to disclosure of information before the court stage. I would like to see taxpayers reciprocate by providing cost information."
42. It was noted earlier that the U.S. seems to be taking the view that it can, indeed, deal with these problems and widen the use of comparables: supra note 37. Reference should also be had to issues respecting "pirate prices": Robertson, supra note 1, at 778, and Lindsay, infra note 116.

where comparables cannot be identified.[43] The report contains elaborate commentaries and specific recommendations in respect of the second and third methods as well as helpful illustrative examples.

As suggested earlier, Revenue Canada should make clear whether it intends to follow the detailed rules in the U.S. and the OECD guidelines and discrepancies between the two sets of rules should be identified by Revenue Canada and resolved.

Some of the problems with these secondary methods were noted by Mr. Gourlay, in his address to the Pharmaceutical Association:

> The resale minus method is not practical in determining the transfer price of an active ingredient where sales prices of the final product vary considerably among different brands. This is often the case in your industry.[44]

In summary, Revenue Canada's Draft Information Circular obviously contemplates that "comparables" often will not be available and reference will be required to the secondary resale and cost plus methods which, on the one hand, have the virtue of at least providing some semblance of specificity and certainty but, on the other hand, are limited by their somewhat rigid and arbitrary nature and, as already noted above, are seen by the governments which rely upon them to have proper application only in defined areas.

The U.S., in fact, has not had as much application of any of the first three methods as it had hoped:

> Presumably the Treasury anticipated that the three methods would cover all but a few intercompany transfers. In fact from August 1966 until April 1968, the Revenue Service agents were instructed to use one of the three methods but no fourth option. A few exceptions were to be handled by special agents on a case by case basis, depending on the facts and circumstances of the individual situations. In theory this approach seems logical. In practice, however, the three methods have not been successfully applied to the extent anticipated.[45]

This leads to "fourth methods".

3. *"Fourth methods"*

Both the OECD and the U.S. rules and recommendations contemplate that a proper determination of intercompany pricing may not arise under the first three methods discussed and that, in any event, these approaches are only presumptively correct, with taxpayers having the right to seek to justify prices determined by reference to other methods or criteria. The Draft Circular (paragraph 24) states the following in respect of "fourth methods":

> A fourth method is really an undefined group of methods, loosely characterized as "all other". These are employed when the formal approaches are impractical. In any case, the methods utilized should reflect an attempt to restate the particular transaction in terms of what would have transpired in an arm's length relationship.

Notwithstanding that the Draft Circular has no prior reference to the possibility of "fourth methods", it seems that Revenue Canada adopts the U.S. and OECD view that such will be permissible. It is not clear that the government intends that, even where one of the first three methods is *prima facie* relevant and applicable, fourth methods may be used; such however is definitely the situation contemplated in the U.S. Regulations where, as already noted, Regulation 1.482-2(e)(1)(iii) states:

> Where the standards for applying one of the three methods of pricing described in subdivision (ii) of this subparagraph are met, such method must, for the purposes of this paragraph, be utilized *unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate.* (emphasis added)

It would certainly be helpful if Revenue Canada clarified its view on this matter in the final version of the Circular.

Under existing Canadian law, the most that could be said is that the wording of subsection 69(2) clearly contemplates that a taxpayer can use any method whatever provided it somehow gives rise to a price which a reasonable person, dealing in its own economic interest, would have adopted; there seems to be no basis under current law for a court accepting, as irrebuttable, determinations made under the first three methods which Revenue Canada would prefer.

Indeed the decision in *Hofert*[46] in respect of the "fair market value" rule is clear support for such proposition.

Curiously the U.S. rules are silent on the nature of "fourth methods" other than acknowledging that taxpayers may seek to develop them.[47]

Two of the leading U.S. cases, *U.S. Steel*[48] and *Du Pont,*[49] involved the Internal Revenue Service departing from the designated order of priority and advocating fourth methods.

In the *U.S. Steel* case it was the IRS which sought to use a "fourth method", in the form of an allocation of overall profit proportionate to costs incurred by the U.S. parent

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43. A criterion enunciated in an introductory section of the OECD's discussion of the resale method and the cost method would presumably be of interest to research and development oriented industries (e.g. the pharmaceutical industry):

> "If a product represents an important innovation, it may be reasonable to attribute the greater portion of the profit to the enterprise concerned with production and research and development (where expenditure on research and development has been incurred) which would have to bear the losses if the product were rejected by the market, whereas with more standardized products the profit element may be due more to the marketing than to the production or research and development activities of the MNE." Supra note 6, at 37.

44. Supra note 4. He also noted that with respect to the pharmaceutical industry "one problem with the cost plus method is that many companies in this industry do not disclose their cost figures".
45. Prof. Burns: supra note 36.
46. Supra notes 2 and 10 and related text.
47. The "fourth method" was acknowledged in 1968 by Mr. Sheldon S. Cohen, at that time Commissioner of the IRS, as follows:

> ". . . in our training program we are emphasizing the provisions of the proposed regulations which give the taxpayer the right to establish a more appropriate rate or charge under the general standards of arm's length dealing. Agents are being reminded of the importance of keeping an open mind and of giving appropriate considerations to taxpayers' arguments justifying an arm's length rate which is at other than at the safe haven rate or charge." (As cited by Joseph B. Mihalov, "Retaining the Section 482 Arm's Length Standard", 60 *Tax Magazine*, 5 (1982) at 331, 334.)

48. Supra note 32, and 40 and related texts.
49. Supra note 33.

and its offshore captive. As discussed earlier, it failed.[50]

But there is also a message for taxpayers in the *Du Pont* case where the court struck down the U.S. taxpayer's blatant attempt to set transfer prices on the retail method so as to allocate profit to a Swiss-based marketing organization. The IRS agreed with the taxpayer that comparable uncontrolled prices were not available. However, the IRS also argued that the taxpayer was not entitled to use the two secondary methods inasmuch as they could not properly factor in the lack of business substance in the transshipment company arrangement. Instead the IRS argued for a fourth method and were upheld by the court, which refused to allow DuPont to merely apply in a rote, mechanical fashion the resale method set out in the Regulations under section 482. The Court stated:

> As we have intimated . . . this total failure of [DuPont's] proof is no surprise. The taxpayer's prices to DISA [the subsidiary] were set wholly without regard to the factors which normally enter into an arm's length price . . . and it would have been pure happenstance if those prices had turned out to be equivalent to arm's length prices. This is not a case in which a taxpayer does attempt, as best it can, to establish intercorporate prices on an arm's length basis, and then runs up against an IRS which disagrees with this or that detail in the calculation. Plaintiff never made that effort and it would have been undiluted luck – which under the Regulation it probably could enjoy – if it had managed to discover comparable resales falling within the resale price method set forth in the Regulation (including adjustment to be made under the Subpart (9).[51]

Accordingly, in DuPont the taxpayer's use of a transshipment company and an apparent tax avoidance motive resulted in the courts disregarding the order of priority of the section 482 Regulations and requiring the application of criteria such as return on capital, that is a "fourth method".[52]

The *Du Pont* decision also reflects the fact that the U.S. courts do not interpret section 482 and the Treasury interpretative Regulations made thereunder so as to oust a proper determination of the facts and circumstances in setting pricing: "The courts have long recognized that the ascertainment of values entails a factual inquiry and is therefore not amenable to determination by the application of fixed rules or mechanical formula."[53]

It has been noted that in the U.S. both taxpayers and the IRS place "much emphasis . . . on the fourth method",[54] and "at present a significant number of cases are decided on the basis of a fourth method".[55]

In a nutshell, in the U.S. it would seem that the Regulations are to a considerable extent concepts of variable content to be filled out by the court in any particular case applying its own subjective judgment in evaluating the evidence and the relationship between the facts and the principles sought to be utilized.

The OECD report is more specific than the U.S. regulations and identifies the following possible "fourth" approaches:

(a) Comparability of profits involving "a comparison of an enterprise's overall performance with that of other similar enterprises in the same or similar circumstances"; it states further that "levels of profit in an industry may, for example, conform to a pattern and an exception to the pattern might indicate that profits were being shifted by artificial transfer prices".[56]

(b) Another approach set out would involve an attempt:

> . . . to allocate some portion of the combined net profit arising from a sale transaction to the various associate enterprises concerned in it on the basis of their proportionate contribution to the final profit (at 43).

Such an approach is described, at 14, as "so-called global" methods which are described, at 14-15, as being:

> . . . necessarily . . . arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation resources . . . . A number of such methods are sometimes advocated, allocating profits in some cases in proportion to the respective costs of associated enterprises, sometimes in proportion to the respective turnovers, or to their respective labor forces, or by some formula taking into account several such criteria. They are all however to some degree arbitrary . . . . [T]o allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various different stages of manufacturing, transportation, marketing and so on.

The report goes on to note, at 16, a concern often expressed by Revenue Canada in auditing multinationals (see above) that it is most difficult for the tax authorities of any one country to have sufficient information about the multinational to fully evaluate such approaches:

> The need would be for full information about the total activities of the whole MNE. While the widest range of such information may be available to the tax authorities in the countries of the parent company in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which the subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the MNE itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company's country if they seek to get the information by way of exchange of information provisions under double tax agreements. Nor can it be generally assumed that the tax authorities of a country of

50. For additional discussion of this case see Yost, George T., "Establishing Intercompany Pricing Comparables after U.S. Steel", 6 *International Tax Journal,* 5 (1980) at 360.
51. As cited by Mihalov, supra note 47, at 339.
52. In a paper delivered to the Thirty-First Annual Conference, Mr. David Tillinghast, a U.S. attorney, noted that the *Du Pont* arrangement seems to be a "prototype for . . . the resale method". However, the court adopted a higher price for goods transferred from the U.S. parent company to the Swiss trading company because the latter's business was "riskless". Mr. Tillinghast found the dicta in the decision was "an invitation to the IRS to turn the transfer pricing field upside down, once more". He noted that the IRS had used an economist to do a rate of return analysis and this was factored into the transfer pricing computations made by the IRS and accepted by the Court. See Tillinghast, David R., "An American View of International Intercompany Pricing Problems", *Report of Proceedings, Thirty-First Tax Conference,* 1979, Canadian Tax Foundation, (1979) at 469 (excerpts from, respectively, at 477, 472 and 477-478). See also Feinschreiber, Robert, "Intercompany Pricing After Du Pont", 6 *International Tax Journal,* 3 (1980) at 222.
53. Trial Judge Willi in *Du Pont* as cited by Mihalov, supra note 41, at 339.
54. Prof. Jane Burns, supra note 36.
55. Singer, supra note 37, at 227. Footnote 12 of the Singer article cites substantial date on the U.S. experience with the various pricing methods.
56. Supra note 6, at 42.

> the subsidiary should in any case be entitled to quite such a wide range of information about the group's worldwide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any MNE and the varied circumstances in situations in which they are carried on must make it impracticable for the tax authorities of a country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison figures produced in different countries by different accounting methods and different legal requirements.

The latter concern relating to the utilization of such alternate methods was clearly stated by James Gourlay in his address to the Canadian IFA Branch Meeting in Toronto last February.[57] Mr. Gourlay expressed the frustration of the Department, at 6, as follows:

> To solve these [pricing] problems we seek information from third parties, especially when we are looking for comparables. However, a lot of the material we need is in the books of the parent company, foreign company, we have no way of getting at those books. As I told you before, in many cases we have experienced a large degree of cooperation. In other cases, we run into refusal to cooperate in any manner at all. In such cases we are not hesitant about issuing requirements and enforcing compliance with those requirements. If need be, we will hold inquiries here in Canada, if that is the weapon we think we need, or we will go to the treaty partners. Certainly we are going to get the information necessary to protect the Revenue.

Another fourth method contemplated by the OECD (at 43) is a comparison of the "yield or return on the capital invested in the relevant or associated enterprise with the yield or return on the capital invested in enterprises carrying on similar activities and requiring the same kind of capital investment".

The OECD sums up the overall situation aptly, at 44, by stating "the methods described do not by any means exhaust the possible techniques and it does not follow that if an approach has not been mentioned it is not to be followed".

The Department's Draft Information circular seems to adopt some of the elements in the OECD report, and notwithstanding the implied criticism thereof in the earlier portion of the Circular where, as noted above, it states that ". . . some taxpayers . . . attempt a shortcut . . . hurrying to a demonstration that, at the bottom line, the Canadian taxable income appears pretty reasonable".[58]

Paragraph 25 of the Draft states:

> One example of the fourth-method application involves a functional analysis of the contribution from each group member involved in producing and marketing a product. The ultimate profit for that product is apportioned among the members according to the relative value and importance of the functions put forth by each. In respect of transfer prices, are they adjusted to produce the desired result.

Revenue's reluctance and concerns respecting such approaches are stated in paragraph 26 where it notes that such a method:

> . . . requires certain arbitrary and subjective decisions regarding the relative values of various functional contributions . . . and they . . . suggest that transfer prices be established in retrospect which would be unlikely in an arm's length relationship.

Paragraph 26 notes, somewhat ambiguously, that these defects in the "fourth methods" illustrate "why the Department, like other countries' tax authorities, place greater reliance on the first three methods". The ambiguity is whether "greater reliance" denotes simply the preference Revenue and other governments have for "comparables" or whether Revenue Canada in fact is of the view that the abundant number of obstacles in applying comparables or the other two specific (secondary) methods are not experienced in Canada or, more forebodingly, that Revenue Canada may choose to ignore the obstacles in order to use the first three methods. Perhaps, as well, the Department has not as yet identified the extent of fourth method use being experienced in the U.S.[59]

In his address to the Pharmaceutical Association, James Gourlay stated that he had received representations from the pharmaceutical industry for "a universal method such as an allocation of profits based on a formula which could include such factors as a return on investment. The attraction of this approach is that it is simple."[60] He then noted that "the universal approach is frowned upon in international tax and business circles because it is unlikely that all countries could agree on a formula that could be applied under their respective tax legislations. The result would be double taxation." This may be compared to the precise comments in the OECD guidelines, the U.S. experience, as well as the present views of the Department set out in the Draft Information Circular.[61]

It is suggested that the application of so called "fourth methods" in relation to the language of section 69(2) requires a showing that pricing has been established in light of business relations and arrangements with other members of the multinational unit which are consistent with the effort of maximizing overall profit for each unit of the group and that it matters not what type of rules, procedures or concepts or evidence are put forward as long as the court would believe that this objective has in fact best been achieved through the pricing arrangements agreed to by the Canadian subsidiary. Or, to put it another way, what section 69(2) requires is a showing that intercompany pricing is determined by and in accordance with good bona fide business purposes or reasons according to good standards, customs and practices of the industry and business generally and not, on the other hand, primarily for the purpose of achieving undue tax effects.[62]

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57. Supra note 4.
58. Paragraph 12 of the Draft Circular.
59. Reference should be made to notes 45, 52, 53, 54 and 55 and related text, although the current initiative by the IRS in the Japanese auto cases, supra note 37, should be borne in mind.
60. Supra note 4.
61. See also negative views respecting "global methods" expressed by John Robertson to the 1982 Conference, supra note 1, at 777.
62. This is the theme of the German guidelines, although the German rules do not specifically recognize "fourth methods", but such seems implicit in S. 2.1.3 and 2.4.6: see section below.

Would the latter approach be accepted by a Canadian court even where the Revenue can apparently show comparables? An affirmative answer may require that the court accept the proposition discussed earlier (and contrary to the position of Revenue Canada as reflected in the Circular) that determinations need not be made on a transaction by transaction basis. The validity of such "fourth methods" in relation to fully integrated multinational corporations gives rise to the following questions, in summary of earlier discussions of these factors:[63]

(1) Are there important business reasons that each unit within the organization require fair and accurate accounting statements?
(2) Would such fair and accurate statements require, inter alia, that the pricing of intercompany transactions (as ultimately affect such statements) portray the most accurate measurement and relative contributions and efforts of each segment of the organization?

The development of prices for intercompany transactions on the basis of the foregoing principles would seem to constitute a reasonable approach and one consistent with the requirements of section 69(2).

In summary, the essence of the task may be to demonstrate that intercompany pricing arrangements are motivated by business reasons and not tax reasons. Relevant factors and information as would support such a contention would include analysis of costing/pricing policy and procedure, the need for and use of accurate financial statements for each member of the group, the need for benefits of integrated operations and the incidence, nature and role of independence of action within a framework of the integrated group. Is such an exercise not an appreciation of the facts of each case, not unlike that involved in other areas of Canadian law devoid of detailed statutory rules such as paragraph 18(1)(a) versus 18(1)(b) or income versus capital gain? What does an Information Circular really add to the debate?

Finally, it should be noted that at paragraphs 27 and 28 Revenue Canada specifically rejects "value for duty" for Customs Act purposes in establishing fair pricing for purposes of the Income Tax Act.

F. Other countries

Developments in other countries are important for two reasons. First, they may be of assistance to the Canadian government (Revenue Canada or the Department of Finance) or the Canadian courts in working out workable rules for Canada. For example, special attention may be useful to the fashion in which the new comprehensive administrative rules in Denmark and Germany accord with or deviate from the U.S. rules and OECD guidelines and reconcile differences between the latter two approaches. Second, consistency of rules between different countries is imperative if double taxation is to be avoided or undue tax avoidance countered.[64]

1. *Australia*

In 1981 Australia enacted anti-avoidance rules to counter improper multinational pricing arrangements. Following on the heels of a decision involving abusive pricing with a Hong Kong transshipment company,[65] sections 136A to 136AG were brought into effect on 28 May 1981. These provisions stipulate in general terms that the arm's length principle would govern intercompany arrangements although no attempt is made to codify detailed rules of the type found in the U.S. Regulations, the OECD report or the Department's Draft Information Circular.

The basic requirement will be a "price between independent persons dealing at arm's length". If the Commissioner is satisfied that pricing does not meet that standard or "where because of lack of information available to the Commissioner or for any other reason, it is not possible or practicable to ascertain an arm's length price", the determination of the Commissioner will be substituted for that which was agreed to between the parties.

The 1981 law also examines intra-company activities, either foreign companies operating in Australia through branches or the converse thereof, with particular attention to branch invoicing and allocation of head office expenses, in order that there be appropriate allocation of overall profits between head office and branch.[66]

2. *Austria*

In Austria, "the arm's length concept is firmly established".[67]

Although there does not appear to be a body of codified rules of the type now being considered by Revenue Canada in the Draft Information Circular, it is understood that the OECD guidelines would be closely followed.

In certain areas, such as payments for management fees to foreign parent companies, the law (Art. 4, para. 4, Income Tax Act) provides substantive requirements for the deductibility thereof.[68]

3. *Belgium*

In line with the approach in most countries, the Belgian Tax Code provides only general anti-avoidance rules to deal with and govern intercompany arrangements. Article 24 of the Tax Code is similar to section 482 of the Internal Revenue Code (requiring proper allocation be-

63. Supra notes 29-30 and related text.
64. In this respect John Robertson's paper to the Annual Conference in 1982 states (supra note 1, at 773):
"Now that the arm's length principle is widely accepted as the basis for assessing intracorporate transactions, Revenue Canada is focussing attention on the development of standard guidelines for the application of that principle by taxation authorities around the world. Standard guidelines will provide a framework, I believe, for rational tax planning and will contribute to greater compliance by multinational companies."
65. *Commonwealth Aluminium Corporation Ltd.*, 143 C.L.R. 646 (1980).
66. See O'Connor, Robert, "Australia Tightens Transfer Pricing Rules", *International Tax Report*, 13 (1981) at 1; Allsop, P.W., "Australia: Transfer Pricing Arrangements", *Tax Management International Journal* 10 (1982) at 28.
67. See Helbich, Franz, "General Problems of Inter-Company Transactions Across The Border", 33 BIFD 8-9 (1979) at 375.
68. This aspect of the issue is specifically dealt with in the Helbich article, ibid.

tween related parties) and rules also arise under Articles 46, 50 and 250 of the Tax Code.[69]

4. *Denmark*

In June (1983) the National Tax Directorate of Denmark issued administrative rules concerning multinational activities.[70]

The rules, patterned on the U.S. Regulations and OECD guidelines, adopted the three primary methods[71] although references to "fourth methods" consist of discussions in section 3.3.5 of methods for analyzing "comparable profits".[72] The specific rules in respect of each of the three primary methods are, as in the case of the new German regulations discussed below, carefully elaborated analyses of underlying factors and considerations. Revenue Canada should consider these rules as well as the others in finalizing its Information Circular, not only for the substantive content but in respect of the issue raised earlier as to whether Revenue Canada's Circular should develop specific rules rather than simply adopt the U.S. Regulations and/or the OECD guidelines by renvoi.

In addition to transfer pricing for intercompany transfers of goods, the Danish rules also deal with intercompany transfers of technology and provision of services.

5. *France*

The major recent development in France in respect of intercompany pricing was the amendment in 1982 of Article 57 of the General Tax Code dealing with tax haven operations. The rules are currently designed to adjust inadequate pricing arrangements between a French company and dependent foreign enterprises or even non-dependent foreign enterprises operating in a defined "tax haven". The mechanics of the law involved include a presumption arising in favor of the Fisc, resulting in a heavy burden of proof on the French company as to the propriety of its pricing arrangements.

6. *Germany*

On 23 February 1983 the Federal Minister of Finance of Germany issued final administrative guidelines on international transfer pricing.[73,74] The basic principle is set out in section 2.1.1 as follows:

> Business dealings between related persons have to be judged for tax purposes according to whether those involved have acted in such a manner as third parties independent of each other would have done (arm's length dealing). The standard here is the relation given in a situation of free competition. The underlying principle is the normal degree of commercial prudence shown by a sound and conscientious business manager.

The guidelines closely resemble the U.S., OECD and Canadian Draft Information Circular. Their tone, however, is far less aggressive, far more conciliatory than the Canadian or U.S. versions. The comparable non-controlled price, resale method and cost plus method are featured. "Fourth methods" are not identified per se but are contemplated in the general principle of sections 2.1.3 and 2.4.6 which state that:

> [Section 2.1.3]
> In allocating income the functions of the individual related enterprises have to be considered. For this purpose particular importance is given to:
> - the structure, organization, division responsibilities and allocation of risks within groups as well as the attribution of properties;
> - which enterprises undertake individual functions (production, assembly, research and development, administration, marketing services); and
> - in what capacity the enterprises perform these functions (whether as principal, agent or as participant on an equal basis in, or representative of, a pool).
>
> The commercial content of the actual activity is the determining factor. A remuneration cannot be allocated to enterprises performing no functions at all; enterprises performing insubstantial functions can only be taken into account according to the economic results which they have actually effected, i.e. in general by means of a cost-orientated remuneration.
>
> [Section 2.4.6]
> In special cases it is not possible to compare the actual circumstances with a similar situation involving unrelated parties, above all where, in applying the criteria of paragraph 2.1.1, business dealings of the kind in question would not have come about between unrelated parties or would have only come about with an essentially different commercial content. In these cases the allocation is to be based on appropriate apportionment of the income arising from the series of transactions overall which sound business managers would have determined.

As in the case of the detailed U.S. Regulations, the German rules seek to account for each condition, factor or circumstance in the transaction which can be quantified or otherwise used in assessing an appropriate arm's length price. For example, one of the six different types of determining factors listed in section 3.1.2.1 is "the special kind, state and quality as well as the innovation potential of the goods and merchandise transferred". Perhaps the degree of flexibility in the general rules is best reflected in an article under section 2.4.2 which states:

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69. See Hürner, M., "The Belgian Tax Code and the Intercompany Transactions Between Local and Foreign Companies", 20 *European Taxation* 8 (1980) at 258.

70. Audit Instructions 1983-3, 10 June 1983, relating to transfer pricing and arm's length principle.

71. The terminology is somewhat different; comparable uncontrolled prices are referred to as "free market prices": see section 3.3.2 of the Instructions; and the cost plus method is referred to as "production cost plus fixed profit": see section 3.3.4.

72. Section 3.3.5 states that "the tax authorities may also find it helpful to compare an enterprise's operating results with other similar enterprises' operating results in the same or similar circumstances. The profit levels in a particular branch often correspond, and deviations from the pattern may indicate that profits are being shifted by means of artificial transfer prices".

73. For informative comment in the pre-existing situation and the new rules, see Strobl, Jakob, "General Tax Problems of Transfrontier Corporate Transactions", 33 BIFD 8-9 (1979) at 378; Strobl, Jakob, "German Tax Audits of Foreign Subsidiaries in Germany: Practice and Experience", 20 *European Taxation* 9 (1980) at 273; Becker, Helmut, "The New German 'Administrative Principles' on Intercompany Pricing", *Tax Management International Journal,* 5 (1983), at 8 (also appearing in 10 *Tax Planning International* 8 (1983) at 3); Hoppner, Horst-Dieter, "German Regulations on Transfer Pricing: A Tax Administration Point of View", *Intertax* 6-7 (1983) at 208; Miles, Andrew, "Germany: Intercompany Pricing and Changes", *Intertax,* 9 (1983) at 335; Jonas, B., "Federal Republic of Germany: New Directive on Intercompany Pricing", 23 *European Taxation* 4 (1983) at 107.

74. It should be noted that the new rules are binding on the German tax authorities but not on taxpayers: Becker, Helmut, supra note 73.

> Market conditions will often make it necessary to use several methods in the determination of arm's length prices. Accordingly, there is no objection that the standard methods (comparables, resale method and cost plus) are tailored to the circumstances of the particular case, combined or complemented by other procedures to take proper account of the market situation. In the examination of transfer prices several standard methods can be utilized.

Although it is difficult to state conclusively on the basis of an initial review, it was seen that the German rules combine the best principles of the U.S. Regulations, the OECD guidelines and up-to-date business custom, procedure and practice, and Revenue Canada and the Department of Finance would do well in considering these carefully in finalizing and formulating either the Information Circular or any future plans for statutory enactment.

7. *Italy*

In September of 1980 the Italian tax authorities issued Circular 9/2267 setting out administrative procedures concerning multinational pricing arrangements. Even though the statutory law was changed subsequently,[75] Circular 9/2267 will retain its interpretative value.[76,77]

The administrative rules set down in circular 9/2267 are patterned on the 1979 OECD guidelines and thus contemplate both the three primary methods (comparables, resale and cost plus) as well as "fourth methods".

8. *Sweden*

The situation in Sweden is similar to that in Canada and other countries such as the U.K. (see below). There is a basic statutory rule requiring an arm's length price in multinational transactions but there are no comprehensive statutory administrative provisions or guidelines. However, the Swedish tax authorities apparently do consider the OECD guidelines or the section 482 Regulations from time to time.[78]

9. *United Kingdom*

Section 485 of the U.K. tax statute reflects the principle of the arm's length rule and governs intercompany transactions. There are neither elaborate rules nor underlying case law.

The Inland Revenue has, however, issued administrative guidelines, "Inland Revenue Guidance Notes on Transfer Pricing and Multinational Enterprises", which, although not law, would apparently serve the same sort of purpose as Revenue Canada's proposed Information Circular.

The Guidance Notes, issued in 1981, closely resemble both the U.S. Regulations and OECD guidelines.[79]

10. *U.S.A.*

Analysis of Code Section 482 Regulations has been integrated in the foregoing text.

G. Conclusion

All of the factors outlined together point to two main conclusions:

(1) The Department's insistence on determining pricing on a transaction-by-transaction basis, pursuant to subsection 69(2), may not be legally correct and, rather, Canadian subsidiaries and other Canadian members of multinational groups may be entitled to demonstrate the requisite reasonableness in the context of the arm's length rule by reference to long term effects as well as those arising out of a particular transaction. This could substantially reduce or perhaps eliminate altogether the relevance and applicability of the three methods advocated by the Department throwing the matter into the realm of the so-called fourth method.

(2) If pricing determinations are, in law, required to be made on a transaction-by-transaction basis, the approach advocated in the Draft Information Circular is conceptually sound. However, the preferred comparable non-controlled price approach often will not be applicable; where such is the case, resort to the two secondary methods (the resale method and the cost plus method) may often be either equally inapplicable and/or susceptible of arbitrary results and taxpayers may well seek to resort to fourth methods as a means of making determinations which involve overall appreciation of the particular facts and circumstances extant.

However, in the latter circumstances the problem arises that Revenue apparently does not relish the idea of resorting to pure factual debates which may well lead to ei-

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75. Article 38 of Presidential Decree 897 of 30 December 1980 reproduced Article 75(4), modifying 3597 of 29 September 1973, and in particular repealing former Articles 53 and 56.

76. See Maisto, Guglielmo, "Tax Treatment in Italy of International Transactions Between Affiliated Companies", 37 BIFD 9-10 (1983) at 408.

77. *The Financial Times, World Tax Report,* September 1983, notes in an item by Owles, David, "Italy – Ruling on Invoicing", that an Italian court applied the OECD guidelines in an exchange control price dispute involving alleged overpricing of goods invoiced to an Italian subsidiary by a foreign group; in judgment No. 7895 of 14 April 1983, the court decided that the comparable non-controlled price rule was not appropriate, by reason of lack of comparability, and used instead the retail price method.

78. In private correspondence from Sten Hamberg, H. Utterstroem Law Firm, Stockholm, it is noted that "few, if any, transfer price cases have been initiated in Sweden. Actually in two recent cases – *Ericsson, Oeberg* – in the past years, corporate taxpayers have successfully defended lower than market prices from Swedish parent companies to overseas subs on a theory of 'vertical integration'." Mr. Hamberg also notes that "over the past four months, a couple of tax auditors have attacked all the oil majors on transfer pricing and on thin capitalization. As Sweden does not know unitary taxation, a few people believe this will be successful, as oil companies have been very strict in applying official list prices."
On 30 December 1983, the Inter-Municipal Fiscal Court of appeal of Stockholm rendered an important decision on the application of arm's length principles to transfer pricing between subsidiary and parent corporations. The decision examined Swedish transfer pricing rules and also relied on the guidelines issued by the OECD. See 24 *European Taxation* 5 (1984) at 167.

79. For the situation in the U.K., including the 1981 Guidance Notes, see: De Vries, Ed, "Intercompany Pricing Provisions in the United Kingdom", *Intertax* 9 (1980) at 294; Current Tax Intelligence – "Transfer Pricing of Multinational Enterprises: Notes for Guidance", *British Tax Review* 1 (1981) at 818; "U.K.: The Transfer Pricing of Multinational Enterprises, Notes by U.K. Inland Revenue", *Intertax* 8 (1981) at 301; Davies, David R., "United Kingdom: Inland Revenue Guidance Notes on Transfer Pricing and Multinational Enterprises", *Intertax* 1 (1982) at 12.

ther resort or to the courts or the enactment of specific rules by Finance.

It would therefore seem that, as a matter of pure law and, to a somewhat surprising degree, the Department's considered opinion after seven or eight years of intensive study and investigation, the question of proper intercompany pricing may be nothing more or less than a question of fact to be determined on a case by case basis. Sometimes the matter is confused by either the taxpayer or the Department seeking to assert principles, or formula approaches, which will not stand the test of full scrutiny, as a means of satisfying the rule of subsection 69(2). Furthermore, as noted elsewhere, it may be no more appropriate to seek remedial statutory rules than in relation to such equally basic issues as distinguishing capital gains from ordinary income or current expenditures from capital expenditures – in all cases what is involved is the necessity of making a factual determination which is not amenable to determination by mandatory rules of law.

The U.S. experience with "rules" has not exactly been a success. The problems, discussed earlier, are reflected in the following comment:

> Because both section 482 and its arm's length standard are ambiguous, frequent requests are made for Congress to provide guidelines or formulas for intercompany transactions. Taxpayers tend to prefer safe haven rules, profit splits and mathematical approaches. Congress, however, has repeatedly refused to attack the ambiguity of section 482. This inaction has effectively left it to the Treasury and the courts to define pricing for intercompany transfers. Such a process is costly, plagued with uncertainty, and seemingly unending.[80]

The Business and Industry Advisory Committee to the OECD perhaps best summed up the true nature of the situation in its response to the OECD report:

> BIAC considers that the OECD report clearly reflects the complicated nature of the problem of intercompany transfer pricing, with all the many and varied aspects inherent in it. BIAC also warmly endorses the comment in the report that it is not possible to "lay down rules that are appropriate to every aspect of every case". This comment constitutes recognition of the fact that to draw up a manual establishing a procedure for determining whether the transfer prices within a group conform to the arm's length principle is simply not possible or feasible.

Rather what is significant is that:

> The report provides a set of parameters which can be applied by tax authorities in forming a judgment on transfer prices and pricing structures within a group. The implicit recognition that there is no such thing as "the right price" but that, in fact, the arm's length principle contemplates a range of prices, prompts BIAC again to express the view that managerial flexibility in regard to transfer pricing policy within a group must not be preempted by Revenue authorities.
>
> Once it has been establishing by appropriate means that prices and pricing within a group are maintained within this range, tax authorities should refrain from attempting to apply adjustments. In such a situation the transfer pricing policy of an MNE group should simply not be susceptible to change under pressure from a Revenue examiner; in other words, it should be respected and accepted.[81]

It is to be noted that this is not inconsistent with the views expressed by James Gourlay to the Pharmaceutical Association where he expressed the Department's concern over large discrepancies in the proper pricing:

> I might mention we are keying in on products where the price differential is substantial. We are not concerned about small percentage differences.[82]

Unfortunately this begs the question when the government and multinational cannot agree on the appropriateness of pricing. Is this not, in fact, the OECD's own view? Consider the following statement by one of its authors, reported by Dr. Verlage, cited earlier:

> In a comment on the tax situation after the appearance of the OECD report on transfer pricing, the following characteristic observation of the report occurs:
> "We have not succeeded in answering all your questions. The answers we have found only serve to raise a whole set of new questions. In some ways we feel we are as confused as ever, although we believe we are confused on a higher level and about more important things."[83]

III. INTERCOMPANY PRICES FOR SERVICES

A. Commissions

Cross-border intercompany transactions involving services may also give rise to disputes between the taxpayer and Revenue Canada. The reasonable price in the circumstances test of subsection 69(2) governs transactions. As in the case of pricing for goods, there are neither statutory nor case made guidelines to assist in determining the reasonable price.

There have been at least some instances of Revenue Canada questioning large scale transactions involving commissions paid by or received from related non-residents in a multinational group. In such disputes, as in the case of pricing for goods, Revenue Canada attempts to identify comparable arm's length commission rates to evaluate the intercompany payment; as in the case of pricing for goods, the taxpayer often objects on the grounds that the third party rate is not comparable for a variety of reasons and that, in any event, the governing "reasonable" principle provides grounds to deviate from any true comparable price identified by Revenue Canada. A court may well accept a presumption that a true third party comparable price should govern, but the taxpayer should have the legal right to deviate therefrom if justified by the facts and circumstances.[84]

Taxpayers have been particularly exercised by the attempts of Revenue Canada to unearth and utilize fairly antiquated industry norms published in sources such as the Dominion Bureau of Statistics for purposes of assessing commission rates between related parties.

The Draft Information Circular does not deal specifi-

80. Burns, supra note 36, at 7,852.
81. Supra note 18, at 286.
82. Supra note 4.
83. Supra note 30, at 293.
84. It may be recognized that such approach would not differ substantially from that which might be expected where the applicable rule is "fair market value" where the latter is governed by principles argued for in the preceding section, and stemming in part from the *Hofert* case, supra note 2.

cally with pricing for commissions. Paragraph 7 of the Draft does specify that "management fees and other payments for services are covered [i.e. under the terms of section 69] . . ." (parenthetical words inserted).

However, the portion of the Circular which deals with "management services" does not focus on fair pricing per se. For example, in paragraph 36 in respect of management fees, the statement "the question of a profit element or markup to the non-resident is not an issue in itself" begs the question. Furthermore, in the introductory paragraph to the pricing rules for transfer of goods, paragraph 15, the Circular states that the principles applicable there "apply to the acquisition or disposal of intangible property . . ." but no reference is made to services.

Inasmuch as paragraph 16 then goes on to incorporate by reference the rules of the Internal Revenue Code and the guidelines of the OECD for purposes of determining fair pricing for goods, it may well be that the Department does not intend, at least consciously, that those rules apply in determining fair pricing for commissions.

If indeed the Department intends that the U.S. rules be used, the test may not be "comparables". Regulation 1.482-2(b)(3) stipulates that the "arm's length charge shall be deemed equal to the cost or deductions incurred with respect to said services by the member or members rendering such services . . .". The Regulation provides for two exceptions to this rule. First, it does not apply where the services:

> . . . are an integral part of the business activity by the member rendering the services or the member receiving the benefit of the services [as defined; see below].

Second, the rule does not apply if:

> . . . the taxpayer establishes a more appropriate charge under the standards set forth in the first sentence of this paragraph [i.e.] . . . the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts.

Regulation 1.482-2(b)(7) deals with the circumstances where the service is integral to the business activity of either the renderer or the renderee. This is considered to be the case where ". . . either the renderer or the recipient is engaged in the trade or business of rendering similar services to one or more unrelated parties"; or ". . . where the renderer renders services to one or more related parties as one of its principal activities" and the rule goes on to further define such circumstances. The Regulation also considers there to be a service business where "the renderer is particularly capable of rendering the services and such services are a principal element in the operations of the recipient" with further rules elaborating thereon. As well, such a business is presumed "where the recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year". It may be noted that the Regulation goes on to provide 16 detailed examples of where the services are to be considered rendered in the context of the business but Regulation 1.482-2(b)(7) does not provide further rules as to how pricing is to be determined other than the third party test cited above under Regulation 1.482-2(b)(3).

The OECD report states that:

> The successive steps involved for tax authorities are identifying the type of service, determining whether a benefit has effectively been conferred on one or more of the associated enterprises . . . and then evaluating the amount of the remuneration appropriate in each individual case.[85]

At page 79 of the report the basic principle for pricing is stated as follows:

> As in other areas of intra-group transfers, the general principle to be followed is that prices for services performed between associated enterprises should be those which would be paid between unrelated enterprises. Consequently such transactions should not be treated differently for tax purposes from similar transactions between unrelated enterprises simply because the enterprises happen to be associated.

It goes on to state:

> Normally to determine the amount of the consideration under the arm's length principle, the open market value of the services rendered would have to be established.

Where comparables cannot be determined, the OECD states that ". . . a cost-orientated method may be helpful in providing an approximation for arm's length prices".

Accordingly, it may be seen that there may be a distinct divergence between the approaches under the U.S. rules and the OECD recommendations and Revenue Canada ought to clarify its intention in this area in the Information Circular.

B. Management fees

Under the general scheme of the Income Tax Act a non-resident is not subject to Canadian tax in respect of fees paid by a Canadian company for services performed outside of Canada unless the price is in some way contingent upon production in Canada. The Part I tax on income from business carried on in Canada does not apply to services performed outside of Canada and thus the subsidiary withholding tax rules of section 153 and regulation 105 have no application; Part XIII would only impose tax on such foreign source services to the extent the price were contingent in a fashion contemplated by subparagraph 212(1)(d)(iii) or (iv).

However, in 1963 an unusual exception to this jurisdictional scheme was enacted, primarily as a means of dealing in part with what was perceived as abusive management charges made against Canadian subsidiaries by foreign parent companies. Paragraphs 212(1)(a) and 212(4) impose a 25% withholding tax, subject to treaty reduction or exemption, on the profit portion of any fee paid for general management or administration, even though performed outside of Canada, by a Canadian company to a non-arm's length resident or even to an arm's length non-resident whose ordinary business does not include such management services. The payment will not be taxable under this rule to the exent that it is "an amount . . . on account of . . . a specific expense incurred by the non-resident person for the performance of a

85. Supra note 6, at 76.

service that was for the benefit of the taxpayer to the extent that the amount so paid . . . was reasonable in the circumstances". It is not clear if the entire amount paid must so qualify.

There are two issues where such fees are charged to a Canadian subsidiary. First, does the amount meet the requirements of section 69 and, second, is any portion subject to the Part XIII tax noted.[86]

1. *Deductibility – Part I*

With respect to the Part I issue, the test clearly arises under subsection 69(2). The Department in Information Circular IT-468 at paragraph 8 states:

> In considering the reasonableness of the fee or charge for purposes of section 67 and subsection 69(2), the Department is prepared to recognize a reasonable markup or profit on specific expenses incurred by the non-resident in performing the services for the benefit of the Canadian payer.

Such a test is not per se troublesome. The Draft Information Circular does not provide any additional guidance with respect to pricing techniques and the queries noted in respect of pricing for commissions would apply equally – i.e. the interrelationship between the Department's views and the diverging rules in the U.S. and the recommendations of the OECD. In particular, the Draft Information Circular states (paragraph 36):

> The question of a profit element or markup to the non-resident is not an issue in itself. The Department would not expect, however, that the Canadian taxpayer would absorb substantially more than its reasonable share of the group's total management and administration expense.[87]

The Department should clarify its views in respect of the applicability of the U.S. Regulations, etc.

The Circular, however, does go on to provide three other specific limitations in determining the deductibility of such fees to a Canadian subsidiary. These rules are, in part, at best dubious.

Paragraphs 31 through 33 focus on whether the services rendered have been for the benefit of the Canadian subsidiary and, for example, specifically carve out as non-deductible any "expenses of the parent in its custodial capacity, i.e. as a shareholder managing its investments and subsidiaries".[88]

The Business and Industry Advisory Committee to OECD in its response to the OECD guidelines concurs with the prohibition of charging "shareholder (stewardship) costs to subsidiaries".[89] However, it does not agree with the "overly broad interpretation of what constitutes shareholder costs". In particular, BIAC believes that:

> Shareholder costs should be limited to only those costs incurred by a parent company solely in its capacity as a shareholder (investor) in the other group affiliates. It should not include any costs attributable to coordinating the various business activities of the group. Costs of internal auditors, for example, should not be included as a shareholder cost. Since examinations carried out by internal auditors are primarily intended to provide information to the parent and the group members which is, *inter alia,* used for management purposes, the notion that the results of an internal audit merely serve to protect the investment of the parent company is not correct, and is a misconception of the role of the internal audit function. BIAC cautions against interpreting the concept of shareholder costs too broadly, inasmuch as the result could be to create a situation where a significant portion of the central costs of a group would effectively not be deductible anywhere.[90]

The Department is insistent that a charge to the Canadian subsidiary "is acceptable only if the taxpayer could derive a real benefit from the related services". Thus, for example, where the taxpayer "is staffed by a management team normally associated with a self-sufficient business, the allocation should be limited to expenses that can clearly be identified for the taxpayer and which do not represent a duplication of services already provided by Canadian personnel".[91]

The Department then goes on at paragraph 35 of the Draft Circular to make the rather extraordinary observation that:

> Since other countries' Revenue authorities are similarly concerned with the allocation of management expenses, there is a real danger of double taxation when services are duplicated in two or more jurisdictions. The multinational group should endeavour to clearly define management responsibilities and line of authority in order to minimize this risk.

This would imply that the Department is prepared to substitute its own business judgment for that of the taxpayer as to how its affairs should be managed and will not allow the deduction for expenses which it apparently considers to arise out of inefficiencies in the operation of

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86. For an excellent analysis generally of these rules and in particular of the various types which may comprise "management fees" and past assessing practice of Revenue Canada see: Lindsay, Robert F., "Canadian Tax Planning Re: Management and Service Fees Paid by a Canadian Corporation to a Related U.S. Corporation", *The Tax Executive,* (T.E.I.), (1983) at 285. See also Hogg, supra note 1, and additional Revenue Canada views reflected in John Robertson's paper to the 1982 Annual Conference, supra note 1.

87. Perhaps the second sentence harbours an intention that there not be a profit element, particularly where one has regard to John Robertson's 1982 paper, supra note 1, at 779:

> "In general, no markup on costs is accepted on charges allocated to Canada except in respect of costs for custom or income-earning services that are of industrial, commercial, or scientific character and are related to the income-producing activity of the Canadian entity. This category may be considered for the allowance of a reasonable markup on costs.
>
> The other broad category of allowable costs can be characterized as shared or accommodation costs – that is, costs that represent the staff, administration or managerial functions of an operation. Since the purpose of centralizing these costs is to provide a benefit to all members of the group through economies of scale and specialization, no markup on these costs is allowed."

88. Converse aspects of this issue were dealt with in the 1981 U.K. case, *Robinson (Inspector of Taxes)* v. *Scott Bader Ltd.,* [1981] S.T.C. 436, where the court decided that the U.K. parent could only deduct the cost of employing an executive to manage a French subsidiary to the extent the subsidiaries of the executive were "solely in its [the U.K. parent's] own interests". To the extent the expenditures are either "solely in the interests of the French subsidiary" or "partly in the interests of the French subsidiary" the salary paid would not be deductible for the U.K. parent in computing its U.K. tax liability. Although the Department's preliminary views in paragraphs 31 to 33 are not quite as restrictive, in the converse circumstances, troublesome issues could arise out of Revenue Canada's view that, as noted at paragraph 32, "where a resident taxpayer is staffed by a management team normally associated with a self-sufficient business, the allocation should be limited to expenses that can clearly be identified for the taxpayer and which do not represent a duplication of services already provided by Canadian personnel".

89. Supra note 18, at 281.

90. Supra note 18, at 292 and 293.

91. Paragraph 32 of the Draft Information Circular.

the multinational. One would think that Revenue Canada might have some difficulty supporting this proposition.[92]

The Department will require that taxpayers "represent" amounts charged as either "reimbursements" or "fees"[93] and will disallow payments which are represented by the taxpayer as being reimbursement of specific expenses incurred by the foreign parent unless "such expenses are identified and invoiced at the time they are charged".[94] In addition, "the intercompany invoice must clearly specify the expenses involved and the basis for their allocation to the Canadian taxpayer. The Department's audit staff will apply this policy to all amounts paid or credited after 31 December 1983".[95]

There is no statutory basis for the requirements set out by the Department in paragraph 39. In addition, the Department will not allow a deduction for a profit element in the amount charged unless the taxpayer "represents the allocation as a 'management or administration fee or charge'".[96] Paragraph 35 of the Circular stipulates that the taxpayer is either to make such representation or is to represent that the allocation is a "reimbursement of a specific expense incurred by the non-resident person for the performance of a service that was for the benefit of the taxpayer" in which case the Department will not allow any "markup" for purposes of section 69(2).[97]

One has great difficulty in understanding how the Department comes to the view that deductibility of amounts charged pursuant to section 69(2) turn on the particular modalities by which they are invoiced to the Canadian subsidiary or paid by the latter, and to the extent that one could demonstrate that in fact a payment otherwise meets the requirements of section 69(2), even if not attended by the mechanisms described by the Department, they presumably should remain deductible. The Department's thinking in this respect is reflected in paragraph 38 which states:

> In the past some taxpayers made regular payments to non-resident parents based on arbitrary amounts, a flat rate of the percentage of sales, etc. When questioned by the Department, these taxpayers proceeded to retrospectively identify specific expenses incurred by the parent which were said to justify the payments. Only if there was a shortfall in the specific expenses would a taxpayer acknowledge a management fee subject to Part XIII tax.

The Department states that it is "such a practice" which is to be subject to the restrictions noted in respect of deductibility and which is "no longer acceptable". Again one has difficulty understanding the interrelationship between section 69(2) and its substantive requirements and questions of evidence and procedure in respect of such charges. As well the statement that "only if there was a shortfall in the specific expense would the taxpayer acknowledge a management fee subject to Part XIII tax" seems to be irrelevant to that portion of paragraphs 35, 37, 38 and 39 that deal with deductibility under section 69. (For the correlative withholding issues, see below.)

The Department takes the view that deductible "reimbursements of specific expenses" may not include charges for "depreciation, capital costs, reserves[98] or other items that are not ordinarily deductible under Part I (e.g. club dues, foreign advertising, personnel or living expenses) . . .".[99] This ties into the "two options" provided in paragraph 35, which would permit the deduction of such amounts to the extent they are represented as part of a "management or administration fee or charge" as opposed to a "reimbursement or specific expense". I believe this view reflects a misunderstanding of the nature of the legal relationship where a foreign parent performs services and charges an amount to a Canadian subsidiary, with or without profit and with or without written agreement. In virtually all cases the parent is acting as principal, not agent: i.e. the parent employs the person who sits in head office and performs a service for, or carries out a function benefitting, the Canadian subsidiary; in such cases any charge it makes is one for a service rendered and the character thereof for Part I purposes is simply that; the cost incurred by the Canadian subsidiary is a fee for services not an item of expense referable to the foreign parent's underlying cost of providing the service. Hence, there is no charge for the things set out in paragraph 37, not even if the charge is computed *by reference* to such underlying costs.[100] It is submitted that, except in the rare case of the parent being an agent (perhaps in a joint R&D program), there is no basis whatever for any part of paragraph 37.

A basic problem with the Draft Dircular is the attempt to coordinate subsection 69(2) with Part XIII. There just is no basis for such an interpretation and the Department should carefully reassess this aspect of the Circular.

The Circular also focuses on expenses which are for the benefit of a number of companies as opposed to for the Canadian subsidiary alone.[101] Paragraph 34 notes that it may be difficult to allocate among the various units of the multinational but "in any event, the basis of allocation should be established in advance and available for examination by the Department".

The Department's insistence on a "benefit" analysis in paragraphs 31-34 perhaps should be considered in the light of the commentary on the OECD report by the Business and Industry Advisory Committee to the OECD. In particular they state:

> In the chapter covering transfer of technology and intergroup services, the report suggests that a group member must demonstrate that it has derived a benefit (or is expected to derive a benefit) in consideration for payments made to another affiliate (often the parent) for services or certain intangible property rights. This concept is acceptable insofar as it relates to specific services rendered and

92. See for example attitude of courts reflected in *Olympia Floor & Wall Tile*, supra note 15.
93. Paragraph 35 of Draft Circular.
94. Paragraph 39 of Draft Circular.
95. Ibid. Presumably the 31 December 1983 date reflected an earlier expectation that the Circular would be finalized and published before 1984. As the Circular had not been released at 22 December 1983, the date this paper was finalized, it is assumed the effective date will be changed.
96. Paragraph 35 of Draft Circular.
97. Paragraph 37 of Draft Circular.
98. Paragraph 37(iii) of the Draft Circular.
99. Paragraph 37(iv) of the Draft Circular.
100. The U.K. decision in *Re Euro Hotel (Belgravia) Ltd.*, [1975] 3 All E.R. 1075; [1975] S.T.C. 682, held that a payment was not interest notwithstanding that it was computed *by reference* to the mechanics relevant to interest computations. This principle would be applicable herein.
101. Paragraph 31 of the Draft Information Circular.

specific property transferred. In addition, however, the parent company of a group often incurs substantial costs for central activities carried on to benefit the group as a whole rather than to benefit any one or more specific affiliates. For example, knowhow of all kinds is available centrally for all members of the group to avail itself of, if desirable or necessary; and a continued stream of information of all sorts (e.g. marketing, advertising, technical, etc.) flows to the subsidiary companies. It seems to BIAC that the members of the group should make an appropriate contribution towards defraying these costs, whether or not specific benefit (actual or intended) can be demonstrated.

> The performance of central services and central activities is inherent in the very nature of a multinational group, and accordingly, it is logical to conclude that the enterprise as a whole is benefitted by the costs incurred for activities carried on by the headquarters unit. In many cases, however, it will not be possible to substantiate that an immediate benefit has been conferred upon the group members, even though they are called upon to bear an allocable portion of such central costs. BIAC believes that it is reasonable that every group member of an MNE should pay its share of these central costs from which it can expect to benefit collectively, each respective share being determined by an appropriate apportionment or formula.[102]

It seems doubtful that the Department's views in paragraph 34 will be construed by them in a manner consistent with this recommendation by BIAC. For example, the comments in paragraph 32 are of concern where it is stated "an allocation of central management expenses to a Canadian taxpayer is acceptable only if the taxpayer could derive a real benefit from the related services". Is this not inconsistent with the BIAC recommendation? Should the latter be followed?

Finally, referring back to the prior section dealing with access to information, the Department states that it will not accept charges made to Canada where the underlying basis is cost incurred by the foreign entity unless it has access to foreign based records. This could affect pricing in each area (for goods or services where the cost plus method is used, management fees, R&D charges, etc.). At paragraph 64 the Draft Circular states:

> The notion of extra-jurisdictional access to books and records was encouraged in the 1976 OECD report, "Guidelines for Multinational Enterprises". Access to foreign cost records is particularly useful when evaluating transfer prices into Canada and cost allocations. In fact, the Department cannot accept an allocation – for example, a management fee or R&D charge – without some access to the records on which the allocation was based.

Then continuing in paragraph 65:

> When denied access to foreign cost records or other critical information, the Department may attempt to obtain such data under the "exchange of information" provisions of the various tax treaties and conventions. There is growing cooperation between tax administrations around the world.

2. *Part XIII withholding*

The Draft Circular also deals with withholding tax obligations in respect of management fees. The Circular foresees a dichotomy corresponding with that established for purposes of deductibility under section 69(2) as described above. In particular, the Department is of the view that where a taxpayer "represents the allocation as a management or administration fee or charge", the entire amount thereof is subject to tax under Part XIII; that is, no part may be carved out under paragraph 212(4)(b) as comprising ". . . any amount paid . . . on account . . . of . . . a specific expense incurred by the non-resident person . . .".[103] In the Department's view, it is only where the taxpayer represents the "allocation as a reimbursement of a specific expense" for purposes of Part I deductibility that the payment can qualify for exemption from withholding pursuant to the aforementioned Part XIII rule, and as already noted they do not consider the amount as being a "reimbursement in respect of a specific expense" where it includes depreciation and other items not ordinarily deductible under Part I.

If the foregoing is correct, there would seem to be a conflict between the Circular and paragraph 8 of IT-468 which states:

> Where the fee or charge exceeds the amount excluded under 4(a) or (b) above (which identifies amounts contemplated under subsection 212(1)(a)), only the excess would be subject to Part XIII tax.

Revenue Canada apparently intends to reconcile this conflict.[104]

Is the Department's interpretation of paragraph 212(4)(b) correct? It would seem that the answer is negative, although it is certainly not free from doubt. A review of the history of section 212(1)(a) and 212(4) and the mischief it sought to address does not seem to support the Department's cause.[105] However, their concerns may be better protected by the scope given the other requirements of paragraph 212(4)(b) and whether these are met in any particular case.

The current U.S.-Canada treaty does not exempt U.S. companies from the Part XIII tax with maximum tax apparently arising at the rate of 15% under Article XI.[106] It is somewhat curious that the new treaty will apparently exempt U.S. companies from Part XIII pursuant to the business profit rule of Article VII; for example, Article XII which deals with 10% withholding tax on royalties for use of proprietory or intangibles or knowhow, etc. does not include any reference to management fees.

C. Licensing agreements and R & D programs, etc.

Issues concerning prices for transfers of technology, know-how, etc. to Canadian subsidiaries feature some or all of the factors discussed in the preceding two sections. Where outright transfers are involved, there may be disputes as to the governing principle (i.e. paragraph 69(1)(a) or subsection 69(2)) as well as the factual determinations to be made, while licenses which do not con-

102. Supra note 18, at 291.
103. Paragraph 35 of the Draft Information Circular.
104. It may be mentioned that IT-468 discusses the difficult issue of distinguishing between charges which are properly "management fees" for purposes of Part XIII (paragraph 212(1)(a)) or for something else which may or may not be taxable under some other provision of Part XIII such as paragraph 212(1)(d). In this context see Lindsay, supra note 86.
105. See Lindsay, supra note 86, and in particular footnote 26.
106. Lindsay, supra note 86, at footnote 31, suggests the rate is not so limited. This turns on the meaning of "earned" in Article XI.

vey full property rights would be governed by the issues under subsection 69(2).

Inasmuch as there generally is very little basis to find any "comparables" in this area, Revenue Canada's assessing initiatives focus to a considerable extent on determining the underlying costs to the foreign transferor or licensor, e.g. its cost of research and development, and comparable charges made to other companies with the group. This entails information from or audit of companies outside of the Canadian jurisdiction and, under the current status of international cooperation, requires voluntary disclosure of such information by the foreign parent or related company, which in many cases is not forthcoming. This can raise the level of dispute between the Canadian subsidiary and Revenue Canada.

The Department's draft Information Circular provides the following guidance as to audit procedure, policy and views in this area.

1. *Sales of intangibles*

The Draft Circular states, at paragraph 15, that the rules for determining proper pricing of goods as described earlier "apply to the acquisition or disposal of intangible property as for example the outright transfer of ownership of a patent".

2. *R & D*

Paragraphs 40-45 of the Circular deal with intercompany charges concerning "research and development". The Department makes the point that unless the Canadian company acquires a proprietary interest of some sort, there really is no basis for a charge to be made to it (except as part of a licensing agreement). The R & D must "be made available for the benefit or potential benefit of the entire group"[107] and while "it is not possible to specify any basis of allocating expenses as being preferable to other alternatives . . . the method utilized should be appropriate to the particular circumstances in each case".[108]

The Department expresses uncertainty as to whether a "profit element" may properly be included in the allocated portion of R & D charged to the Canadian company:

> The question of a profit element for the R & D function is even more uncertain. A number of ancillary questions come to mind:
> (i) Is it realistic to always attribute a profit to the R & D function? (Surely unsuccessful research over a period of time should logically be reporting a loss.)
> (ii) Could R & D report a profit in a year when the group as a whole is showing a loss?
> (iii) What possible basis could be used to calculate the appropriate markup?
> (iv) Is not R & D more in the nature of a cost centre?[109]

Then, somewhat ambiguously, paragraph 44 of the Circular states that "the question of a profit element for the research function does not arise in itself"; the Department should eliminate the uncertainty between paragraphs 43 and 44.

As in the case of commissions and management fees, the Draft Circular does not make clear the extent, if any, to which determination of fair pricing, in respect of R & D, is to accord with the U.S. Regulations and the OECD report and then, where relevant, the manner in which differences between those two sets of rules are to be resolved.

The Department notes, at paragraph 45, that withholding tax requirements under Part XIII, relating to payments for R & D or other proprietory or non-proprietory technology, are fully discussed in IT-303.[110] They state that the exemption provided under subparagraph 212(1)(d)(viii) of the Act[111] does not apply where this is "a profit element for the R & D function". In the Department's view if there is such a profit element, "the total amount of the payments under the arrangements would attract Part XIII tax". This interpretation, which does not appear to form part of paragraphs 29-32 of IT-303[112] dealing with "bona fide cost sharing arrangements", is consistent with the Department's restrictive views respecting the exemption from withholding tax under subsection 212(4) discussed above in the section on management fees. Any challenge to the Department's interpretation of either can probably be considered together with the other.

3. *Licensing agreements*

Paragraphs 46 to 54 of the Draft Circular deal with licenses for the use of technology, whether proprietory or otherwise (i.e. knowhow). The Circular again makes reference to IT-303 for a discussion of the Part XIII withholding tax requirements.

A lump sum payment made by a Canadian company for use but not outright acquisition of technology is exempt in the hands of a U.S. recipient under the current Canada–U.S. treaty but would not be so under Article XII of the proposed (1980) Canada–U.S. treaty. The Federal Court of Appeal in *Saint John Shipbuilding*[113] suggested in that case that such payments are contemplated by subparagraph 212(1)(d)(i) and were found to be exempt only by reason of the particular provisions of the current treaty.

The Circular focuses on the means of establishing a proper royalty rate for use of technology. Paragraph 50 states:

> Ideally, the intra-group royalty rate should be determinable by reference to an arm's length comparable royalty [in the absence of which] the best that can be expected is to draw comparisons with royalty rates in the same industry or similar industry involving relatively similar products, similar market conditions and similar licensing arrangements.

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107. Paragraph 40 of the Draft Circular.
108. Paragraph 38 of the Draft Circular.
109. Paragraph 43 of the Draft Circular. See also paragraph 30 of Interpretation Bulletin 303, which deals with "Know-how and similar payments to non-residents".
110. See note 109.
111. There is an exemption from withholding tax on a payment made under a bona fide cost sharing arrangement under which the person making the payment shares on a reasonable basis with one or more non-resident persons research and development expenses in exchange for interest in any or all property or other things of value that may result therefrom.
112. Supra note 109.
113. *Sain John Shipbuilding & Dry Dock Co. Ltd.* v. *The Queen*, 80 DTC 6272 (F.C.A.).

The Department makes clear, at paragraph 52 of the Circular, that it is really a facts and circumstances test:

> It is not possible to make specific comments about the royalty rates that are acceptable to the Department. There are arm's length royalties at various levels – even within a single industry – and no "safe haven" limits have been developed.

The circular lists the criteria considered pertinent in developing a royalty rate, at paragraph 53:

(a) prevailing rates in the industry;
(b) terms of the licence, including geographic limitations and exclusivity rights;
(c) singularity of the invention, and the period for which it is likely to remain unique;
(d) technical assistance, trademarks and knowhow provided along with access to the patent;
(e) profits anticipated by the licensee.

A somewhat obscure statement, which should be clarified, is then made respecting the last item:

> In connection with (e), profits anticipated, the Department would expect that a Canadian licensee could demonstrate the value of intra-group licences by a marginal analysis. The gross margin after royalties in respect of products produced under licence, should ordinarily be at least as high as the gross margin on other products which are not subject to royalties.

Although the cost accountants may find this clear, as a statement of the principle relevant to determining legal effects, it is clearly less than adequate and indeed seems discordant with the first four factors recited.

As in the case of other types of payments discussed earlier, Revenue should clarify its intentions concerning the applicability of rules in the U.S. or as recommended under the OECD respecting transfer of technology through licensing arrangements.

IV. INTERCOMPANY LOANS

The Department's comments in the Draft Circular respecting "use of money" are somewhat difficult to fully comprehend. Aside from making the reasonable point that "interest payable on inter-group loans should reflect arm's length rates – which would necessarily be affected by numerous factors including the amount of the loan, credit rating of the borrower, security involved, exchange risk related to the respective currencies, purpose for the loan, renewal provisions and term of the loan" (as well as "by reference to the condition of the capital market at the time the loan was arranged")[114] – the balance of this portion of the Circular seems to dwell on whether or not interest, provided for in a loan to a Canadian company, must be paid.[115]

Apparently the statement in paragraph 60 of the Circular – that "the Department's position is therefore to presume that loan interest should be payable, subject to any important extenuating circumstances that a taxpayer may bring forward" – contemplates situations where interest charged to Canadian companies is forgiven. If this is correct, the Circular should detail more fully the Department's concerns and views of the consequences, to both lender and borrower, where interest is forgiven.

Indeed it is suggested that this section of the Circular be restated to make more clear its objectives and the consequences that flow for taxpayers.

V. COMPETENT AUTHORITY

In Canada, intercompany pricing issues generally have not culminated in litigation. Either the parties settle or, particularly where the U.S. is involved, attempts are made to resolve the issue through a competent authority procedure.[116] "Solving" the issue from Revenue Canada's standpoint entails acceptance of its assessing position or some part thereof by its counterparts in the other country (in the U.S. context, the Internal Revenue Service) with correlative adjustment to the tax accounts of the foreign parent or affiliated company in its home country; "solving" the issue for the Canadian subsidiary entails establishing equilibrium of overall taxes as between the two jurisdictions of the multinational group – that is, in theory, any addition to the Canadian subsidiary's income and Canadian tax liability is to be offset by corresponding reductions of foreign taxes of the multinational.

Inasmuch as the adjustments rarely are in fact equivalent, in their entirety,[117] the Canadian subsidiary and its foreign parent may oppose competent authority procedure as the solution to the issue, particularly if the taxpayer believes it has a strong case. Assuming, nonetheless, that both Revenue Canada and the taxpayer are prepared to accept competent authority, what may be expected from the foreign tax authority? Until recently, where the U.S. was involved, Revenue Canada inspired adjustments seemed to be readily accepted, leading to an increase in Canadian tax and reduction in U.S. taxes for the group.

The I.R.S. now seems to be looking more critically at competent authority procedures stemming from Revenue Canada initiatives. Revenue Canada and the Canadian subsidiary may agree to settle all other aspects of a proposed assessment except the intercompany pricing matter, and to proceed to competent authority, but with the Candian taxpayer conserving (through protective objections) the right of appeal in the event that an acceptable solution does not ensue.

An interesting variation on competent authority procedure under treaty is the strongly worded recommendation by the Business and Industry Advisory Committee to the OECD that all OECD member countries subscrib-

(continued on p. 426)

114. Paragraphs 61 and 62 of the Draft Circular.
115. Loans made by Canadian corporations would be governed by the specific rules of section 17 of the Act.
116. For the Canadian experience with "competent authority procedure" see Ward, David A., "Pricing and International Transactions", *Report of Proceedings of the Twenty-Eighth Tax Conference,* Canadian Tax Foundation, Toronto, November 1976, at 136; and Lindsay, Robert F., "Intercompany Pricing and Competent Authority Application", *1982 Corporate Management Tax Conference,* Canadian Tax Foundation, at 250. See also Robertson, supra note 1, at 775.
117. The overall Canadian taxes imposed would usually include ancillary Part XIII taxes.

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1984 issue. See also Erratum (p. 193 of the May 1984 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Zambia

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(B. 13.217)

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Transfer Tax Act, 1984.
Lusaka, Coopers & Lybrand, 1984. 6 pp.
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ASIA & THE PACIFIC

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Hong Kong, Business International Asia/Pacific Ltd. [1111-1119 Mount Parker House, Taikoo Shing, Hong Kong], 1984. 282 pp., 500 Sfr.
Study describing possible business strategies in developing Asia (excluding, thus, Japan, Australia and New Zealand), designed to assist executives in assessing the various countries of developing Asia for their business and profit potential.
(B. 56.325)

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Taxation laws of Indonesia.
Singapore, Asian Pacific Tax and Investment Research Centre [2 Nassim Road, Singapore 1025], 1984.
Loose-leaf publication containing the English text of the tax laws of Indonesia introduced in 1984. The first three laws – comprising general tax provisions and procedures, income tax, value added tax on goods and services and sales tax on luxury goods – and regulations and decrees promulgated 31 December 1983 are included. Explanatory memoranda to the statutes are also published. This publication will be kept up to date by forthcoming supplements.
(B. 56.326)

Korea

TAXATION IN KOREA.
International Tax and Business Service.
New York, Deloitte Haskins & Sells, 1983. 70 pp.
Introduction to taxation in Korea for use as background when considering the idea of doing business in that country. The information is up to date as of October 1983.
(B. 56.324)

Malaysia

TAXATION IN MALAYSIA.
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New York, Deloitte Haskins & Sells, 1984. 66 pp.
Introduction to taxation in Malaysia for use as background when considering the possibility of doing business in that country. The information is up to date as of January 1984.
(B. 56.323)

Philippines

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EUROPE

Europe

CAMPBELL, Dennis.
Legal aspects of doing business in Western Europe.
International Business Series. Volume I.
Deventer, Kluwer, 1983. 451 pp., 225 Dfl.
Guide to legal aspects of doing business in Western Europe, with studies prepared by local authors. An introduction by Jack J. Coe Jr. aims to identify some of the structural components and areas of concern which characterise the trade and legal environment in Western Europe (European Community). Per country description deals with company law, labor law, foreign exchange, banking, patents and trademarks and taxation. The countries discussed are Austria, Belgium, Denmark, Finland, France, German Federal Republic, Greece, Ireland, Italy, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom.
(B. 105.407)

Austria

KODEX DES ÖSTERREICHISCHEN
Rechts. Steuerrecht. Stand 1.1.1984.

6. Auflage mit der Zinsertragsteuer.
Vienna, Industrieverlag Peter Linde, 1984. 540 pp., 250 AS.
Source book containing the texts of all Austrian tax laws effective as per 1 January 1984. New, updated editions will be published once or twice per year.
(B. 105.343)

GAIER, Richard.
Handbuch der Steuerformularien.
Vienna, Verlag Dr. Anton Orac, 1984. 408 pp., 915 AS.
Handbook containing many tax forms used in practice and an explanation thereof.
(B. 105.276)

PÜHRINGER, Johann.
Die Besteuerung des Arbeitslohnes.
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(B. 105.181)

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Integration im RGW (COMECON).
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France

'T HART, Willem.
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Munich, Verlag C.H. Beck, 1984. 209 pp., 29 DM.
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Düsseldorf, IdW-Verlag, 1984. 725 pp., 29 DM.
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(B. 105.368)

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(B. 105.364)

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13. völlig neubearbeitete und erweiterte Auflage.
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Schriften des Betriebs-Beraters. Band 55.
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(B. 105.238)

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(B. 105.365)

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Wiesbaden, Forkel Verlag [Postfach 2120], 1984. 280 pp., 69 DM.
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(B. 105.183)

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Umsatzsteuer für 1983.
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Düsseldorf, IdW-Verlag, 1984. 1357 pp., 51 DM.
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Zürich, Handelskammer Deutschland-Schweiz [Talacker 41, CH-8001 Zurich], 1982. 56 pp., 30 Sfrs.
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(B. 105.431)

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Direct taxation. The role of incentives.
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The report examines the role of incentives and the Irish system of direct taxation. The Commission looks at the need for incentives and the criteria to be adopted to decide whether incentives should be introduced. Current fiscal and other incentives in Ireland are critically analysed and a number of recommendations made in order to achieve a simpler, more equitable and more efficient taxation system.
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(B. 105.423)

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Brochure on the legal aspects of foreign investment in Poland.
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Articles written by various authors on several tax matters on the occasion of the 20th anniversary of the Centro de Estudos Fiscais.
(B. 105.355)

Sweden

HANDLEDNING FÖR RÖRELSE-
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Stockholm, Liber Förlag [Sorterargatan 23, Vällingby S-16289 Stockholm], 1984. 536 pp., 153.90 Skrs.
Revised edition of handbook explaining the income taxation of business and agriculture with respect to the 1984 income tax year.
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Stockholm, Liber Förlag [address see above], 1984. 431 pp., 141.75 Skrs.
Revised edition of handbook on income taxation re 1984 income other than from business and agriculture, which is treated in a separate handbook.
(B. 105.395)

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(B. 105.408)

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(B. 105.268)

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37th Congress IFA, Venice 1983.
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Contributions by various authors, including B. Visentini, M. Lainé, R. Kleeberg, O. Stanley, I. Claeys Bouuaert, G. de Ulhôa Canto (Points of view peculiar to non-European countries, especially those of Latin America).
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Thirty-fourth edition.
The standard and authoritative guide to educational, scientific and cultural institutional, scientific and cultural institutions all over the world.
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NOBES, Christopher.
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A directory of tariff schedules.
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General overview of the economy, international trade, taxation, foreign exchange, labor law, incentive measures for investment measures for investment and export.
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MIDDLE EAST

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Cologne, BFAI, 1984, 43 pp.
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The English text of the company law is appended.
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Toronto, Richard de Boo, 1984. 3823 pp.
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commentary attempts to provide the layman with
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1984 cumulative supplement No. 1. Text.
Boston, Warren, Gorham & Lamont [210 South
Street], 1984. 629 pp.
This supplement brings the text of the main
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legislative and administrative developments.
(B. 105.362)

FOREIGN AND U.S.
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International Series.
New York, Ernst & Whinney [153 East 53rd
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International Series.
New York, Ernst & Whinney [address see
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Morristown, Financial Executives Research
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Cambridge, The Law School of Harvard
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of international tax evasion and avoidance.
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the use of offshore banks and companies.
Hearings before the permanent subcommittee on
investigations of the committee on governmental
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(continued from p. 420)

ing to the pricing guidelines should also institute a system of "corresponding adjustments" designed to ensure that reallocations made by one country cannot lead to double taxation. In its response to the OECD guidelines, this point was made especially in regard to situations where, as in the case of Canada–U.S. transactions, both units of the multinational are dealing in high tax jurisdictions:

> Where for example there are transactions within an MNE involving two countries having the same approximate rate of taxation, then it will generally not matter to the MNE where the profit is allocated, since the total tax liability of the group would not be substantially affected. The two tax authorities involved, however, view the matter differently, since each of these has a fiscal interest in the income allocation process and, therefore, the observation of the arm's length principle . . . . Therefore, BIAC considers that the OECD report should have set forth and endorsed a mandatory system of corresponding adjustments binding on all members of the OECD.[118]

118. Supra note 18 at pages 288 and 289.

Conference Diary

SEPTEMBER 1984

International Bar Association: Twentieth Biennial Conference (including: measures against treaty shopping; important new developments in national tax legislation as well as current activities of international organisations in the tax field; residence and transfer of residence of bodies corporate). Vienna (Austria), September 2-7 (English).

Commonwealth Association of Tax Administration (CATA): Technical Conference 1984 (including: incentives in tax systems for (a) economic, (b) social objectives). Apia (Western Samoa), 6-12 September (English).

International Tax Planning Association: Monte Carlo Workshop. Monte Carlo Workshop (including: foreign investment in French real estate – the new rules; decontrolled investment companies – a convenient marriage of U.S. and European investors; non-domiciled individuals working in the U.K.; the new rules, etc.). Monte Carlo, 13 and 14 September (English).

The Bureau of European Taxation & Trade: Double taxation relief in Europe (symposium). London (United Kingdom), 24 September (English).

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina), 16-21 September (English, French, German, Spanish).

OCTOBER 1984

Kluwer Seminars: Financing a multinational group (including: financing alternatives for a multinational group of companies and their tax consequences, with special regard to multinationals operating in Europe). Frankfurt/M (German Federal Republic), 10 October (English).

Asian-Pacific Tax & Investment Research Centre: 2nd Asian-Pacific Tax Conference. Singapore, 16-17 October (English).

University of Miami: 39th Annual University of Miami Tax Conference. Miami (U.S.A.), 15-19 October (English).

Annual meeting of the German Tax Law Association: Basic international tax problems. Heidelberg (Federal Republic of Germany), 8-9 October (German).

Confédération Fiscale Européenne: ourth Congress of Tax Consultants (current state of tax harmonisation in the European Communities; form versus substance; taxation of leasing; practical implication of the harmonisation of direct taxes and of VAT and other indirect taxes; equity financing and tax incentives for new business activities; losses in a group of companies). Brussels (Belgium), 18-20 October (English, French, German).

NOVEMBER 1984

International Tax Planning Association: Hong Kong Seminar. Hong Kong, 26 and 27 November (English).

Legal Studies & Services Ltd.: 101 Inland Revenue Practices and Concessions. London (United Kingdom), 30 November (English).

DECEMBER 1984

U.K. Tax Congress Ltd.: 4th Annual U.K. Tax Congress; 1984 Developments & Finance Act (including transfer pricing, golden handshakes, share options and incentives, trading losses and withholding taxes). London (United Kingdom), 6-7 December (English).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian-Pacific Tax & Investment Research Centre, 2 Nassim Road, Singapore 1025. Tel. 235-1954/1959/1667. Telex: RS 50257 APTIRC.

The Bureau of European Taxation & Trade: Co-ordinator Miss Audrey Evelyn Bone, 606 Bryer Court, Barbican, London EC2 (United Kingdom).

Commonwealth Association of Tax Administration (CATA): Marlborough House, Pall Mall, London SW1Y 5HX (United Kingdom).

Confédération Fiscale Européenne (C.F.E.), General Secretariat, Dechenstr. 14, 5300 Bonn 1, Federal Republic of Germany.

German Tax Law Association (Deutsche Steuerjuristische Gesellschaft), Postfach 52 04 29, 5000 Cologne 51, Federal Republic of Germany.

International Bar Association: 2 Harewood Place, Hanover Square, London W1R 9HB (United Kingdom).

International Corporate Tax Planning: contact Professional Development Services Department. The Institute of Chartered Accountants in England & Wales, P.O. Box 433, Moorgate Place, London EC 2P 2BJ (United Kingdom).

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

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

Kluwer Seminars, P.O. Box 23, 7400 GA Deventer, Netherlands

Legal Studies & Services Ltd., Bath House, 56 Holborn Viaduct, London EC1A 2EX, United Kingdom.

National University of Singapore: c/o Faculty of Law, Singapore 0511 (Republic of Singapore).

University of Miami - Conference Center. School of Continuing Studies, 400 S.E. Second Avenue, Miami, Florida 33131, U.S.A.

U.K. Tax Congress Ltd.: Grovenor House, 20 London Road, Horsham, West Sussex RH12 1AY. Tel.: 0403-56113.

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V. BIBLIOGRAPHY

Dr. Otto L. Walter receives Doctorate Honoris Causa

The Editors of the *Bulletin for international fiscal documentation* are pleased to announce that on 10 June 1984

Dr. Otto L. Walter received the degree of Doctor of Laws, *honoris causa*, at the New York Law School, together with Representative Geraldine A. Ferraro (candidate for the Vice-Presidency of the U.S.A.), Judge A. Leon Higginbotham, Jr. (U.S. Court of Appeals for the Third Circuit) and Professor Eugene V. Rostow (currently Sterling Professor of Law and Public Affairs at Yale University and Director of the Arms Control and Disarmament Agency).

The degree was in recognition of Dr. Walter's teaching activities which included international tax law, multinational business law, transnational business transactions and accounting for lawyers.

The Laudatio pronounced is reproduced below:

Distinguished international lawyer and citizen of the world, Otto L. Walter emigrated to America from his native Germany and has served both countries with honor and distinction. A founding partner of the New York law firm, Walter, Conston & Schurtman, Otto Walter is supremely eminent in the fields of foreign and international tax law, and generously shares his expertise with the students of New York Law School as an adjunct professor.

Born in 1907 in Hof, Germany, in northern Bavaria, Otto Walter, the son of a notary, was nurtured on the classics and groomed to follow his father's footsteps. After studying economics and civil and canon law at the University of Munich, and earning a doctorate of law from the University of Erlangen in 1930, Otto Walter was well prepared to make significant contributions to his chosen profession of law. But greater tests of persistence and tenacity were at hand.

With the rise of the Third Reich, Otto Walter was arbitrarily disbarred and his future plans dashed amid his country's violent turmoil. Like so many others of his talented countrymen, Otto Walter fled the evils of Nazi domination and emigrated to the United States. Here, like so many of his countrymen, he was forced to start afresh.

Exercising the foresight and diligence which were to become the hallmarks of his career, Otto Walter moved from bookkeeper to accountant and then to the formation of his own firm, O.L. Walter & Company. His knowledge of German law and his fluency in European languages attracted foreign clients and American businessmen to the fledgling firm. It was inevitable that the former lawyer was soon besieged with legal queries.

So once again, Otto Walter became a student of law, this time at New York Law School. A superior student, he was named a member of the Board of Editors of the Law Review and received his J.D. from New York Law School in 1954.

Six years later he formed a partnership and founded a firm for the practice of law: The practice grew, as did the firm's outstanding reputation in the area of international tax and commerce. Otto Walter's unique blend of knowledge and experience in German law, American law, taxation and accounting so enhanced his effectiveness that other law firms became his clients. His subsequent success as an international lawyer was still further augmented by scholarly texts authored by himself and his law partners. A member of the Munich law firm of Ott, Weiss, Eschenlohr & Partner, Otto Walter has written in his native German works that are as esteemed in Germany as are his American writings here in the fields of accounting, taxation, economics and international law.

Ever the elegant continental gentleman, Otto Walter brings not only his talents and skills as a lawyer and scholar, but also his considerable personal charm to an illustrious career. It is no wonder that he has been honored with the German Order of Merit and in 1982 the Cross of Merit of the Republic of West Germany.

Since 1976, Professor Walter has been a distinguished member of the Law School's adjunct faculty. Though a part-time faculty member, he has had a significant impact upon his students and has given continuously of his energy, imagination and resources. Recipient of the Dean's Medal and the Distinguished Alumnus Award, Professor Walter's commitment and vision for New York Law School has been undeviating.

Professor Otto Walter, in recognition of your outstanding professional accomplishments, often in the face of adversity, your contribution towards strengthening international bonds of law, and your tireless work on behalf of New York Law School, the Board of Trustees is pleased and honored to confer upon you the degree of Doctor of Laws, honoris causa, with all the rights, privileges and honors thereunto appertaining.

Professor Walter has collaborated with the International Bureau of Fiscal Documentation for many years, in particular in the publication of:
HANDBOOK ON THE UNITED STATES–GERMAN TAX CONVENTION / HANDBUCH ZUM DEUTSCH–AMERIKANISCHEN DOPPELBESTEUERUNGSABKOMMEN.

This major bilingual loose-leaf work in four volumes was originally published in 1967. It is produced in cooperation with Prof. Dr. Helmut Debatin, Mr. Ernst Weber and Mr. Henry Conston, and is still widely recognized as the most specialized, indeed unique, work in its field.

The Chilean Income Tax Reform

By Pedro Massone

Contents

I. INTRODUCTION

A. Historical survey of Chilean income taxation

The first general Income Tax Law was enacted on 2 January 1924 under No. 3,996. This law introduced a schedular income tax system, under which tax was levied on six categories of income each one subject to a different flat rate, i.e. first category: income from immovable property; second category: income from movable capital; third category: income from industry and commerce; fourth category: income from mining and metallurgy; fifth category: income from independent work; and sixth category: income from independent personal services.

During 1925 two important taxes were added to these schedular taxes. Decree-Law 330 published on 18 March 1925 established a global complementary tax levied at progressive rates on the global income of resident individuals and at a flat rate on entities not distributing their income. Further, Decree-Law 755 published on 21 December 1925 introduced an additional tax levied on income derived by branches of foreign companies and by non-resident individuals.

Law 8,419 published on 10 April 1946 consolidated the income tax legislation into a single law maintaining the 6 categories, the global complementary tax and the additional tax levied on non-residents.

Law 13,305 of 6 April 1959 amended the Income Tax Law then in force (i.e. Law 8,419) and introduced the "restatement of net worth", i.e. global adjustment for inflation.

Law 15,564 published on 14 February 1964 reduced the number of categories to two, introduced a special tax on capital gains and replaced personal deductions with a system of personal credits.

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Decree 824 published on 31 December 1974 introduced a special tax on corporations (additional rate) and replaced the global adjustment for inflation with the "adjustment of assets and liabilities", i.e. integral adjustment for inflation.

Finally, the income tax legislation was amended by Law 18,293 of 31 January 1984, which provided for the gradual elimination of the tax on stock corporations (additional rate) and the income tax on professional income (second category tax), and introduced the principle that the individual income tax and the income tax on non-residents was levied only on income withdrawn, distributed or remitted abroad.

B. The income tax before the reform

Just before the 1984 reform, income tax legislation included two schedular or category taxes, a tax on stock corporations (additional rate), an individual income tax (global complementary tax) and a tax on non-residents (additional tax). Mention should also be made of the housing tax which was governed by a separate law.

First category tax was paid by stock corporations, other legal entities, de facto companies, sole proprietorships and by individuals on their business and investment (unearned) income. Thus first category income included business income, unearned income and, in general, all income other than income from dependent or independent personal services. First category tax was levied at a flat 10% rate.

The tax on stock corporations (additional rate) was paid by stock corporations and partnerships limited by shares, in addition to first category tax. This additional rate was applied on that part of income which could be distributed as dividends to shareholders and which, if distributed, would have been subject to the individual income tax (global complementary tax) or to the tax on non-residents (additional tax), as the case might be. The additional rate was levied at a flat 40% rate.

In order to compensate for the payment of the additional rate, shareholders could credit an amount equal to 40% of dividends and similar profit distributions against the individual income tax (global complementary tax) or against the tax on non-residents (additional tax), as the case might be.

The housing tax was levied at a 5% rate on income from agriculture, industry, commerce, mining and similar activities. If the housing tax exceeded a certain amount, the taxpayer could: (i) deposit 50% of the tax with the State Bank and use these funds to build houses for his workers; or (ii) finance directly the construction of houses for his workers and use up to 50% of the housing tax for this purpose.

Second category tax was paid by individuals on their income from personal services. The second category included employment income and income from professional and other independent personal services rendered by individuals or by professional partnerships. Second category tax was levied on employment income at progressive rates ranging from 0 to 58% and on income from independent personal services at a flat 7% rate. Employment income was exempt from the global complementary tax but was taken into account for determination of the rate (exemption with progression).

The individual income tax (global complementary tax) was due by resident individuals on their global income at progressive rates ranging from 0 to 58%.

The tax on non-residents (additional tax) was paid by branches of foreign companies and, in general, by non-resident individuals and entities. The additional tax was levied at a 40% rate.

The system was criticized because it taxed income too heavily, produced the effect of promoting the distribution of income and favored loan financing as compared with equity financing.

C. The purpose and original content of the Reform Bill

The purposes of the tax reform are explained in the message that the Executive Branch sent with the Reform Bill to the Government Junta (legislative body) for approval.

The message states that the principal purpose of the amendment was to solve the problem of low propensity to save and to correct the financial structure of enterprises by allowing them a greater capacity for saving and investment.

In order to attain these purposes, the bill revoked first category tax, the tax on stock corporations (additional rate), second category tax (only when levied on independent personal services), and the housing tax.

The bill kept the second category tax in force, as regards income from dependent personal work, and the progressive individual income tax levied on global income (global complementary tax) under a new name (impuesto sobre la renta global); under the Bill, however, this tax was to be levied on income actually paid to the individual or distributed to him. If the income distributed by an enterprise was reinvested by the recipient in another enterprise, the income so reinvested would not be taxed. For foreign enterprises, income was taxed upon withdrawal or remittance abroad.

The fact that the new system of income taxation was aimed at taxing the income actually paid to an individual or withdrawn by him from an enterprise for purposes other than investment produced effects which were similar to those of an expenditure tax.

In addition to the aforementioned approximation to the expenditure tax, individuals were permitted by the Bill to choose to pay a full fledged expenditure tax instead of the new tax on global income. If the taxpayer chose the expenditure tax, he was required to report his net worth, liabilities and received income in order to calculate the tax.

This meant that the expenditure tax proper was treated as an alternative to the ordinary system established by the reform. Under the message, the expenditure tax was not introduced as a general taxation system due to the difficulty of implementing it, but the possibility of giving it a normal and general character was not excluded for the future.

D. The final content of the Reform Law

The original Reform Bill was amended twice and the form was finally approved with important changes.

Under the final draft of the new law, the first category tax is kept in force but a credit is granted when taxable income is subsequently subject to the individual income tax or to the tax on non-residents.

The tax on stock corporations and the second category tax levied on independent personal services are to be gradually eliminated.

The progressive rates of the second category tax levied on employment income and of the individual income tax are also gradually reduced.

Income derived by individuals from companies or businesses is subject to individual income tax only upon withdrawal by, or distribution to, the individual taxpayer. Likewise, income derived by non-residents is subject to the tax on non-residents once remitted abroad.

The expenditure tax was not approved and in its place resident individuals are permitted to deduct from their taxable income a percentage of certain investments.

In general, the reform comes into force as from taxable year 1984 (assessment year 1985). Special rules are provided, however, for the entry into force of some specific rules.

This article will cover the Chilean income tax after the amendments introduced by Law 18,293. The discussion will not, however, refer to the Income Tax Law in its entirety; it shall focus only on its principal features and especially on those areas where changes have been introduced or which have special interest for enterprises, investors and non-residents.

The changes introduced by the reform are summarized in Table 1.

Table 1

	Taxable year 1983	*Taxable year 1984*	*Taxable year 1985*	*Taxable year 1986*
First category tax	10%	10% creditable	10% creditable	10% creditable
Tax on stock corporations (additional rate)	40% creditable	30% creditable	15% creditable	nil
Employment income (2nd category tax)	progressive 0 - 58%	progressive 0 - 57%	progressive 0 - 56%	progressive 0 - 50%
Income from independent personal services (2nd category tax)	7%	3.5%	nil	nil
Directors' fees (2nd category tax)	7%	nil	nil	nil
Individual income tax (global complementary tax)	progressive 0 - 58%	progressive 0 - 57%	progressive 0 - 56%	progressive 0 - 50%
Tax on non-residents (additional tax)	40%	40%	40%	40%

II. GENERAL ASPECTS OF THE CHILEAN INCOME TAX

A. General description

The Chilean Income Tax Law combines schedular and global taxes and encompasses:

- first category tax;
- tax on stock corporations;
- second category income tax; and
- tax on non-residents.

First category tax is paid by corporations, legal entities, de facto companies and by individuals on their business and unearned income.

The tax on stock corporations (additional rate) is paid by corporations and partnerships limited by shares in addition to first category tax. In order to compensate for this tax, the individual shareholder is entitled to a credit. This tax and the corresponding credit are being phased out, to be fully eliminated as from taxable year 1986 (assessment year 1987).

Second category tax is paid by individuals on their income from employment and professional activities and from other independent personal services. As regards income from professional activities and from independent personal services, this tax is being phased out, to be fully eliminated as from taxable year 1985 (assessment year 1986).

The individual income tax (global complementary tax) is paid by resident individuals on their combined income.

The tax on non-residents (additional tax) is paid by non-residents (individuals or legal entities).

B. Taxable income

1. The concept of income

Under Chilean law, income is defined as the entries representing profits or benefits produced by ownership or by economic activities and all benefits, profits or increases of wealth, accrued or realized, whatever their nature, their source or their name. The concept of income is therefore a broad one and includes:
- all the periodic profits produced by ownership, investments, industry, business or work; and
- all increases in wealth, with only those exceptions specifically provided for by the law itself.

In other words, the law taxes not only gains derived regularly and periodically from a permanent source but also capital increases whatever their nature, source or denomination. As a consequence of the aforesaid concept, all items of income are taxable, except those specifically excluded from the concept of income and those specifically exempt.

2. Receipts not considered income

Article 17 of the Income Tax Law enumerates several types of receipts which are not technically considered to be income for tax purposes. This means that such income is fully exempt from any income taxation.

3. Income categories

Chilean tax law divides income according to its source into 2 categories and levies a separate tax on each category.

First category income includes all income, other than income from dependent or independent personal services, realized by individuals or by professional partnerships. First category tax is specifically levied on:
- income from agriculture and immovable property;
- interest on bonds, debentures, loans, deposits and guarantees; dividends on shares of foreign corporations not doing business in Chile; and annuities payable during the life of a person;
- profits from industry, trade, mining, fishing, air transportation, banking, insurance, building and similar activities;
- commission income earned by brokers and commission agents with established offices; income derived by schools, hospitals, clinics and similar activities; and
- all income not specifically taxed or exempted.

Second category income includes employment income and income from professional and other independent services realized by individuals or by professional partnerships. Second category tax is specifically levied on:
- wages, salaries, bonuses, participation in profits, any other compensation paid to employees and retirement pensions; in this case, second category tax can be a single and final tax (e.g. if the recipient has no other taxable income);
- fees and other income derived from independent personal services; second category tax on this kind of income is being phased out, to be fully eliminated as from taxable year 1985 (assessment year 1986). For participations in profits and fees paid to members of the board of directors and other boards of corporations, second category tax was eliminated as from taxable year 1984 (assessment year 1985).

C. Territorial scope

1. General allocation rules

Unless there is a special provision to the contrary, individuals and legal entities domiciled or resident in Chile are subject to tax on their world-wide income. Non-residents are subject to income tax on their income from Chilean sources.

Foreigners who settle in Chile are subject, for a period of 3 years from the date of their entry into the country, to income taxes on income from Chilean sources only. This period may be extended.

If foreign-source income is subject to tax, only net income is considered, excluding that which is not available for reasons of force majeure, acts of God or by legal provisions of the country of origin.

2. Concept of Chilean domicile and residence

The Income Tax Law does not contain any special provision defining domicile for tax purposes. Therefore, the rules contained in the Civil Code must be applied, in particular when it defines domicile as residence in a given place with the real or presumed intention of remaining there.

Domicile, therefore, may be construed as the conjunction of a material element (residence) and a formal or intentional element (the real or presumed intention of keeping such a place as permanent residence).

Domicile in Chile is not lost through temporary absences or lack of residence; thus an individual who is not actually residing in the country is considered domiciled for tax purposes if he leaves the country but retains the principal seat of his business in Chile, even if such activities are carried on through a partnership.

Residence in Chile for tax purposes is established solely on the basis of physical presence in the country. Thus, an individual is considered as resident whenever he remains in Chile for more than 6 months within a calendar year or for more than 6 months within any 2 consecutive assessment years.

3. Concept of Chilean-source income

Chilean-source income includes:
- income from property located in Chile and income from activities developed in Chile irrespective of the domicile or residence of the taxpayer;
- royalties or rights for the use of trademarks as well as similar payments for the exploitation in Chile of industrial or intellectual property;
- income from shares issued by a corporation established in Chile; the same rule applies to holdings in other companies;
- income from debt-claims if the debtor is domiciled in Chile; and
- income from coastal trade within Chile.

4. Avoidance of double taxation

(a) Unilateral measures

Chilean law does not include general measures to avoid double taxation. The law, however, provides for some particular rules which may prevent double taxation.

Thus, aliens who settle in Chile are only taxed on Chilean-source income for a period of 3 years. This term can be extended by the tax administration. Foreign-source annuities and pensions are exempt from taxation. Interest may be exempt from taxation in specified cases (see V.D.2. below).

(b) Treaty measures

Chile was a member of the Andean Group until the end of October 1976 when it withdrew. Upon withdrawal, Chile promised to comply with decisions and agreements on double taxation. Chile, however, has not yet ratified Decision 40 referring to the subject.

Chile also entered into a treaty with Argentina in 1977 for the avoidance of double taxation of income and capital. This treaty is not yet in force.

D. Taxable period and allocation of income

1. Taxable period

The taxable period is 12 months except for special cases (i.e. opening and closing periods).

The taxable period ends on 31 December of each year, but the tax administration can, in special cases, authorize that taxable periods end on 30 June. This kind of authorization is not frequently granted.

2. Allocation of income

Business income is allocated to the period during which it originates and is subject to first category tax and to the tax on stock corporations (additional rate) on an accrual basis. This income and income not subject to first category tax may be subject in the hands of owners, partners or shareholders to the individual income tax or to the tax on non-residents but, as from taxable year 1984, this tax is due only if the income is withdrawn, distributed or remitted abroad. As from taxable year 1984, the taxation of income withdrawn by the owner of a sole proprietorship or distributed to the partners of a partnership in order to be invested in an enterprise subject to the obligation to calculate its income by means of accounting records (general rule) is deferred until withdrawal from, or distribution by, such enterprise. In those cases in which the amount of income of a partnership, limited partnership or limited liability company is presumed, the income is deemed to be automatically distributed to the partners, proportionally to their partnership or company rights. The presumed income of a sole proprietorship is deemed to be withdrawn by the owner at the end of the taxable period.

The changes introduced as regards the moment at which liability to income tax arises represent one of the most important amendments of the income tax reform. In fact, although the first category tax and the tax on stock corporations are still levied on an accrual basis, the importance of these taxes is diminished or will disappear because a credit is granted on income subject to first category tax and the tax on stock corporations is being phased out.

However, under the new rules, the individual income tax and the tax on non-residents are levied once the income is withdrawn, distributed or remitted abroad.

III. TAXATION OF RESIDENT COMPANIES

A. General description

Resident entities are normally subject to first category tax. This rule applies to partnerships, limited partnerships, limited liability companies, stock corporations, partnerships limited by shares, de facto companies and sole proprietorships. Resident stock corporations and partnerships limited by shares are also subject to the tax on stock corporations (additional rate). Note, however, that the tax on stock corporations is being phased out, to be fully eliminated as from taxable year 1986 (assessment year 1987).

B. Taxable persons

It appears from what has been said above that first category income tax is applicable to stock corporations, other legal entities, de facto companies, sole proprietorships and individual investors. The tax on stock corporations (additional rate) is levied instead on resident stock corporations and partnerships limited by shares, provided they have been created in conformity with Chilean law.

C. Taxable income

1. The concept of income

As explained above, resident entities are subject to first category tax and may also be subject to the tax on stock corporations. First category income tax is normally levied on actual results computed on the basis of full accounting records. There are, however, taxpayers for whom results are computed on the basis of simplified records. In addition, in certain cases, the amount of the income may be presumed.

The tax on stock corporations is levied on that part of income which may be distributed as dividends to shareholders and which, if distributed, would be subject to the individual income tax (global complementary tax) or to the tax on non-residents (additional tax), as the case may be. Excluded from the taxable base are:
(i) receipts not considered to be income;
(ii) income which is exempt from the individual income tax (global complementary tax);
(iii) dividends received from other companies if paid out of sums which have already been subject to the tax on stock corporations (additional rate) or which are excluded from the taxable base thereof (e.g. income mentioned in (i) and (ii));
(iv) payments not allowed as a deduction in the computa-

tion of first category tax, provided the recipient, not being a shareholder of the payor, is duly identified. This group includes that part of profits belonging to general partners of partnerships limited by shares.
If the computation of the taxable base of the tax on stock corporations (additional rate) results in a loss, this loss (which is different from the first category loss) can be deducted in subsequent periods without time limit.

In order to compensate for the payment of the tax on stock corporations (additional rate), shareholders can take a credit on dividends and other similar profit distributions against their personal income tax.

2. Receipts not considered income

Article 17 of the Income Tax Law enumerates several types of receipts which are not technically considered to be income for tax purposes. Such receipts are fully exempt from any income taxation and include, e.g.:
(i) capital contributions received by a legal entity from its stockholders or partners, and the non-distributed excess over par value paid in which is obtained by a corporation when placing shares issued by itself on the market;
(ii) the distribution of profits and of accumulated reserves made by corporations to their shareholders in the form of stock dividends, provided that such profits and/or reserves have been duly capitalized in the corporation, or any increase in the par value of the shares realized by capitalization of the company's reserves;
(iii) the refund of capital and its revaluations as authorized by the law, provided they do not correspond to capitalized profits which are subject to the payment of the income tax upon distribution.

3. Exempt income

This law also provides for a list of items exempted from first category tax, which includes:
(i) dividends paid by Chilean corporations or by foreign corporations developing activities in Chile;
(ii) interest and similar income in certain cases (see IV.B.3(c)); and
(iii) income exempt in accordance with special laws.

The exemptions mentioned in (ii) and (iii) do not apply when interest is derived from a loan or financial transactions by business enterprises which report their income on the basis of a balance sheet and financial records.

D. The computation of taxable income

1. General description

In the computation of actual income subject to first category tax, it is first necessary to establish gross income by deducting from gross receipts the direct cost of goods and services purchased. Then it is necessary to calculate net income by deducting from gross income expenses which are necessary for the production of income. In order to arrive at taxable income (renta líquida imponible), net income must be further adjusted for inflation and the adjusted net income should be corrected in order to conform to the tax rules.

The tax on stock corporations (additional rate) is levied on that part of income which may be distributed as dividends to shareholders and which, if distributed, would be subject to the individual income tax (global complementary tax) or to the tax on non-residents (additional tax), as the case may be.

More specifically, the taxable amount to which the tax on stock corporations (additional rate) applies includes the following items:
(a) first category taxable income;
(b) income not included in first category taxable income (e.g. income which is exempt from first category income tax but subject to the individual income tax (global complementary tax), and income from participations in a partnership or limited liability company);
(c) first category losses incurred in preceding periods. This means that losses allowed as a deduction for computation of first category taxable income are disallowed for computation of the additional rate.

2. Gross receipts

Gross receipts include all revenues from activities taxed under the first category, excluding only those amounts which are not technically considered income.

In the case of first category taxpayers who keep accounting records, gross receipts include revaluations referred to in IV.A.3(b)(vi), (vii) and (viii). Foreign exchange differences favorable to the taxpayer are also added to gross receipts.

As a rule, income must be included in the commercial year in which it accrues, but income from securities, credit instruments and interest is taxable only when realized.

Banks, financial enterprises and similar institutions are subject to income tax not only on income collected or accrued but also on interest received in advance.

3. Costs

The direct cost of goods and services which are necessary to produce the income is deducted from gross receipts in order to arrive at gross income.

4. Business expenses and other deductions

Expenses paid or due during the commercial year which are necessary for the production of income are deducted from gross income in order to arrive at net income.

The law also provides that, under certain limits and conditions, the deduction of some items is specifically allowed in the computation of third category income (business profits).

The following discussion shall cover only those specific deductions which are most important in the category or which have been amended by the reform.

Bad debts

Bad debts written off during the year are deductible, provided the debt was registered in due time and normal collection procedures had no success; reserves for bad debts are normally not allowed as a deduction.

Payments to reserve funds and write-offs of debts included among debts due (cartera vencida) of banks and financial institutions are deductible in accordance with joint instructions of the Superintendency of Banks and Financial Institutes and the tax administration.

Mining licenses

Mining license fees (patentes mineras) paid during the 5 years preceding the year in which exploitation is commenced are treated for income tax purposes as organization expenses and depreciated in accordance with the corresponding rules.

Losses

Losses incurred by a business or enterprise during the accounting period (año comercial) are deductible, including those resulting from crimes against property (theft, arson, etc.). The losses are computed under the same rules used for the computation of taxable income.

The deduction can be taken in the taxable year (año comercial) in which the loss was suffered. If profits of that year are not sufficient to cover the loss, it will be set off against retained profits and, if such profits are still not sufficient, carried forward to the following year, and so on, without limit. When losses are carried forward to subsequent years, their amount is adjusted for inflation in accordance with the changes in the consumer price index.

Organization expenses

Organizational or setting up expenses can be deducted with a period of up to 6 years as from the date of such expenses or the date on which the enterprise starts producing income, whichever is later.

Promotion expenses

Promotional expenses for new articles produced by the taxpayer are deductible. The taxpayer can choose to amortize the expense in 3 consecutive years as from the date of the expense.

Salaries and other employment income

Wages, salaries, and remuneration paid for personal services are deductible including bonuses (gratificaciones) paid in accordance with the law or a contract. Voluntary participations and bonuses (gratificaciones) granted to employees and workers are deductible, provided they are distributed proportionally to wages, salaries, seniority, number of dependents or other general rules applicable to all employees or workers of the enterprise.

In the case of remuneration paid to persons who, due to their controlling position in the enterprise, could influence the amount of their remuneration, the deduction is limited to that part which in the opinion of the tax administration is in conformity with the importance of the enterprise, its reported income, services rendered and capital profitability.

The deduction of remuneration paid for services rendered abroad is allowed, provided it is substantiated with genuine documents and if in the opinion of the tax administration the remuneration is necessary or instrumental to the production of income in Chile.

Wages paid to the individual owner or partner working for the enterprise are not deductible.

5. Adjustment of income

(a) Adjustment for inflation [1]

Net income must be adjusted as follows:

- a deduction must be allowed for items such as: revaluation of the initial net worth according to inflation rates; revaluation of debts payable in foreign currency or submitted to inflationary updating, provided it has not previously been deducted;
- certain items must be added, such as: a revaluation of fixed and realizable assets, generally calculated according to inflation rates.

(b) Adjustment to tax rules

In order to obtain the net taxable income, the adjusted net income must be corrected in order to conform with tax rules.

Thus, several items duly revalued, if previously deducted, must be added, including: interest on and the revaluation of, the owner's or partner's assets; compensation for personal services of the taxpayer or his family; personal expenses of the taxpayer and his family; capital expenditures; disbursements related to receipts not considered income or exempted from income tax; and some benefits granted to controlling persons, shareholders, owners or partners.

Moreover, several items duly revalued, if previously added, must be deducted, including: dividends, profits from partnerships, exempt income, etc.

E. The computation of the tax

1. Tax rates

Business income, investment income and, in general, unearned income are subject to first category tax at a 10% rate. However, a 10% credit is granted, upon distribution or remittance, against the liability to the individual income tax (global complementary tax) or to the income tax on non-residents (additional tax). Note that stock corporations and partnerships limited by shares are also subject to the tax on stock corporations (additional rate). The rate of this tax is 40% up to taxable year 1983, 30% for taxable year 1984, and 15% for taxable year 1985. This tax is fully revoked as from taxable year 1986 (assessment year 1987).

2. Tax credits

No credit is granted for foreign taxes.

1. For further information on the adjustment of income for inflation, see 9.03 in the Chilean chapter of *Corporate Taxation in Latin America* (published by the International Bureau of Fiscal Documentation).

F. Taxation of particular items of income

1. Dividends paid to resident entities

Dividends paid by Chilean corporations (or by foreign corporations doing business in Chile) to resident legal entities are exempted from first category tax. Dividends paid by Chilean corporations to resident legal entities are also exempted from the tax on stock corporations (additional rate).

Dividends paid by foreign corporations not doing business in Chile to resident legal entities are included in first category income and, when paid to a resident corporation, in the income subject to the tax on stock corporations (additional rate).

Stock dividends representing the capitalization of profits or reserve funds are exempt from the personal income tax. The same exemption applies to refunds of capital when a corporation is liquidated.

2. Interest paid to resident entities

Interest is subject to first category tax unless specifically exempt. When interest is realized by business enterprises that report their actual income on the basis of a balance sheet, it must be included among gross receipts. Moreover, if the recipient is a resident stock corporation or partnership limited by shares, interest is included in taxable income for the tax on stock corporations (additional rate).

3. Royalties paid to resident entities

Royalties paid to residents are added to business income and subject to first category tax. Moreover, if the recipient is a resident stock corporation or partnership limited by shares, the royalty is included in taxable income for the tax on stock corporations (additional rate).

4. Service fees paid to resident entities

Service fees paid to resident enterprises are added to business income and taxed under first category rules. Moreover, if the recipient is a resident stock corporation or partnership limited by shares, the fees are also included in taxable income for the tax on stock corporations (additional rate).

5. Capital gains realized by resident entities

Capital gains derived from habitual transactions are generally treated as business income and subject to normal income taxation.

Habitual transactions are presumed to exist, without right to rebuttal, in the case of subdivision of urban land or sale of flats or apartments, provided the transfer occurs within 4 years from acquisition or construction of the building, as the case may be.

Habitual transactions are presumed to exist (in this case with right to rebuttal) in the case of transfers of other immovable property, provided the transfer occurs within one year from acquisition or construction.

Normal income taxation specifically applies to gains derived from the transfer of:

- shares in stock corporations provided the gain is derived from habitual transactions;
- shares in stock corporations provided the transfer occurs within one year as from their acquisition (note that gains from the transfer of shares acquired before 31 January 1984 are subject to normal income taxation only if the gain is derived from habitual transactions);
- immovable property forming part of the assets of an enterprise reporting its actual income under first category rules;
- mines provided the gain is derived from habitual transactions;
- water rights[2] transferred by taxpayers subject to the obligation to declare their actual income under first category rules or where the gain is derived from habitual transactions;
- copyrights or industrial property transferred by a person other than the discoverer or author; and
- bonds and debentures, provided the gain is derived from habitual transactions.

Capital gains subject to special taxation or exempt from income taxation are discussed in IV.B.6.

IV. TAXATION OF RESIDENT INDIVIDUALS

A. Taxation of combined income

1. General description

Resident individuals are subject to a personal income tax (global complementary tax) which is levied on their combined income at progressive rates.

The progressive brackets used for computation of the personal income tax of individuals are measured in tax units which are periodically adjusted for inflation. Under the Chilean Tax Code, the "tax unit" is a sum of money which is established by law and is periodically adjusted for inflation. The "tax unit" is adjusted every month, thus it is also referred to as a "monthly tax unit". The Tax Code also refers to an "annual tax unit" which is used, for example, for the computation of annual income taxes assessed upon a return. The "annual tax unit" is the tax unit corresponding to the last month of the corresponding taxable year (año comercial) as multiplied by 12 or by the number of months included in the taxable year (año comercial). This means that Chile has a "tax unit" or "monthly tax unit" which changes every month and an "annual tax unit" pertaining to the entire taxable period. For example, the amount of the "tax unit" for July 1984 is 3,401 pesos and the amount of the annual tax unit for taxable year 1983 (assessment year 1984) is 38,076 pesos.

2. Taxable persons

(a) Taxable persons in general

The global complementary tax is levied on:

- resident individuals;

2. Farmers may obtain a concession permitting them to use a certain quantity of water for irrigation purposes. This right (water right – derecho de agua) is a right in rem which may be sold as property.

- undivided inheritances, for the income arising in the calendar year of the death of the deceased and during 2 subsequent calendar years;
- income arising from deposits made in the name of persons not yet born;
- income arising from deposits made under a will or having a similar origin; and
- income arising from goods held by a person under any form of trust (título fiduciario), provided the beneficial owner of the income is unknown.

(b) Rules for married couples

Married couples are, as a rule, required to file a joint income tax return. This applies where:
- the spouses have joint ownership of their property (sociedad conyugal), which in Chile is the ordinary regime;
- the spouses have agreed before the marriage or at the time of the marriage to have their property separated (separación total convencional de bienes) but one of the spouses has received power from the other spouse to administer or dispose of his goods; or
- the spouses have, after their marriage, agreed to have separate property (separación total convencional de bienes), but:
  - have not actually allocated or liquidated the joint property,
  - in fact hold their property as joint property, or
  - one of the spouses has received power from the other spouse to administer or dispose of his goods.

If the wife, however, derives income from business or work exercised separately from her husband, a separate return is filed for such income. Other income of the spouses is, in those cases listed above, reported in a joint return.

Married couples must file completely separate returns if:
- the property of the spouses is separated by virtue of the law (e.g. in case of divorce) or by a court decision;
- the spouses have agreed before the marriage or at the moment of the wedding to have their property separated (separación total convencional de bienes) and neither spouse has received power from the other spouse to administer or dispose of his goods; or
- the spouses have agreed after their marriage to separate their property, provided the joint property has been effectively allocated or liquidated and neither spouse has received power from the other spouse to administer or dispose of his goods.

3. Taxable income

(a) The concept of income

The individual income tax is levied on the total income of the taxpayer, whatever its source, i.e. on the taxpayer's world-wide income. It should be noted, however, that, after the reform, the individual income tax is applied upon collection, withdrawal or distribution of the income.

(b) Exempt income

Receipts are not subject to the individual income tax in those cases in which they are not considered income under Article 17 of the Income Tax Law. As explained above, the Income Tax Law enumerates several types of receipts which are not technically considered to be income for tax purposes. Such receipts are fully exempt from any income taxation and include:

(i) indemnity payments received for effective material damages and indemnity payments received for non-material damages which have been duly declared by the Courts;

(ii) indemnity payments received for work-related accidents, which may consist of fixed amounts or pensions;

(iii) sums received by the beneficiary of life pensions or life income from Chilean stock corporations the purpose of which is to grant life pensions or life income;

(iv) the distribution of profits and of accumulated reserves made by corporations to their shareholders in the form of stock dividends, provided that such profits and/or reserves have been duly capitalized in the corporation, or any increase in the par value of the shares realized by capitalization of the company's reserves;

(v) the refund of capital and its revaluation as authorized by the law, provided they do not correspond to capitalized profits which are subject to the payment of income tax upon distribution;

(vi) the revaluation and amortization of bonds, promissory notes and other documents of credit issued by the Government, by Governmental entities or by the municipalities, provided they do not belong to business enterprises;

(vii) the revaluation and amortization of mortgage bonds, of deposits in the Chilean State Bank, the Chilean Housing Corporation and in Savings and Loans Associations, of saving certificates of the Central Bank of Chile, of bond and promissory notes of the Central Agency (Caja) of Savings and Loans, of mortgages of the national system of savings and loans and of saving deposits in cooperatives, provided they do not belong to business enterprises; and

(viii) the revaluation of cash loans, bonds, promissory notes, bills, and mortgage bonds up to a percentage representing the appreciation due to inflation, provided they do not belong to business enterprises.

In addition, income from movable capital (capitales mobiliarios) such as interest and pensions is exempt from the individual income tax provided:
- it is derived by employees or by certain other small taxpayers;
- it does not exceed the aggregate of 10 monthly tax units at the value they have in December of the corresponding year; and
- the recipient has no income or activity other than those referred to.

4. Computation of taxable income

(a) Taxable amount

In the computation of taxable income, it is first necessary to establish the global gross income which comprises the aggregate of income collected or withdrawn by the taxpayer.

Taxable income from the various categories is specifically included in global gross income provided it is collected or withdrawn. Income exempt from category taxes is also included in global gross income and is taxable for purposes of the individual income tax. Income specifically exempt from the individual income tax is normally taken into account in order to apply progressive rates (exemption with progression).

Exempt income is fully excluded from the computation if the exemption originates from a contract concluded with the competent authority in accordance with a law in force when the benefit was granted. Also excluded from the computation are those receipts not technically considered to be income for tax purposes, which are listed in Article 17 of the Income Tax Law.

The members of partnerships, limited partnerships and limited liability companies must include in their global gross income that part of receipts, profits, gains, or participations which is withdrawn from the enterprise. They must also include in their global gross income that part of presumed income which proportionally belongs to the member.

The taxable amount is represented by global net income calculated by deducting from global gross income:
- the immovable property tax paid for property producing income which is included in global income; and
- social security contributions paid during the pertinent taxable year (año comercial) by an individual entrepreneur or partner on income allocated to him by an enterprise or by a company subject to first category tax which calculates its income on the basis of accountancy records and a general balance sheet.

(b) Investment allowances

Resident individuals can deduct from their taxable income determined on the basis of actual receipts a percentage of investments made. Resident individuals can, per taxable year, deduct from their taxable income determined on the basis of actual receipts:

(i) 20% of the amount invested in shares (acciones de pago) in open stock corporations, provided that the shares are held for more than one year (this condition must be complied with on 31 December of the corresponding year);

(ii) 20% of the sums invested as a first owner (primer titular) in promissory notes representing non-transferrable deposits made with banks and financial companies, provided:
- 180 days have elapsed as from the date of issue (this condition must be complied with on 31 December of the corresponding year);
- the notes have at least a one-year term; and
- the document contains a provision specifically stating that the advance collection of the funds will result in the loss of the interest accrued;

(iii) 20% of the sums invested as a first owner (primer titular) in other securities similar to those mentioned in (ii), provided they are registered with the Superintendency of Securities and Insurance or are mentioned in paragraph 2 of Article 3 of Law 18,045 (this provision refers to securities issued or guaranteed by the state, Government agencies or the Central Bank of Chile); and

(iv) extraordinary payments to pension funds made during the taxable year.

The aggregate of the deductions that the taxpayer can take under (i), (ii) and (iii) above cannot exceed in any one year 20% of taxable income. The deduction that the taxpayer can take under (iv) cannot exceed in any one year 25% of taxable income. Moreover, the aggregate of all deductions referred to cannot exceed in any one year the value of 50 annual units on 31 December of the corresponding year (see IV.A.1.). The balance of sums that cannot be deducted in a particular year cannot be carried forward to subsequent years.

5. Computation of the tax

(a) Tax rates

The combined income of individuals is subject to tax at progressive rates which will in the future be gradually reduced as shown in Table 2.

Table 2

Taxable year 1983 (assessment year 1984)		Taxable year 1984 (assessment year 1985)	
Taxable income (annual tax units)	*Percentage to be applied on taxable income (per bracket)*	*Taxable income (annual tax units)*	*Percentage to be applied on taxable income (per bracket)*
— 10	—	— 10	—
10– 25	8	10– 25	7
25– 40	13	25– 40	12
40– 55	18	40– 55	17
55– 70	28	55– 70	27
70– 85	38	70– 85	37
85–100	48	85–100	47
100– —	58	100– —	57

Taxable year 1985 (assessment year 1986)		Taxable year 1986 (assessment year 1987)	
Taxable income (annual tax units)	*Percentage to be applied on taxable income (per bracket)*	*Taxable income (annual tax units)*	*Percentage to be applied on taxable income (per bracket)*
— 10	—	— 10	—
10– 25	6	10– 30	5
25– 40	11	30– 50	10
40– 55	16	50– 70	15
55– 70	26	70– 90	25
70– 85	36	90–120	35
85–100	46	120–150	45
100– —	56	150– —	50

(b) Tax credits

Resident individuals may credit against their liability to the individual income tax (global complementary tax):
- a personal credit of 10% of 1 annual tax unit per year (3,808 pesos for taxable year 1983);
- a credit for each dependent of 10% of 1 annual tax unit per year (3,808 pesos for taxable year 1983).

Resident individuals can also credit against their liability to the individual income tax:
- the single tax withheld on employment income (second category tax), as adjusted for inflation;

- 10% of that part of global gross income which has previously been subject to first category tax;
- a percentage of dividends paid out of income subject to the tax on stock corporations: 40% for taxable year 1983, 30% for taxable year 1984, and 15% for taxable year 1985; and
- a credit calculated by applying, to exempt income included in the global gross income (other than employment income), the average or effective rate resulting from the application of progressive rates of the individual income tax to the aggregate of the taxpayer's income.

B. Taxation of particular items of income

1. Business income

Business income of resident individuals is subject to first category tax as discussed in III. This income is also subject to the individual income tax (global complementary tax) at progressive rates.

2. Dividends paid to resident individuals

(a) Taxation of dividends

Dividends paid by Chilean corporations (or by foreign corporations doing business in Chile) to resident individuals are exempt from first category tax but are subject to the personal income tax on individuals (global complementary tax). However, shareholders can credit a percentage of dividends and other similar profit distributions against their liability for the personal income tax.

A credit of 10% of dividends paid out of sums subject to first category tax is granted as from taxable year 1984. Shareholders can also credit against their tax liability a percentage of dividends paid out of sums subject to the tax on stock corporations (additional rate). This credit is 40% for taxable year 1983, 30% for taxable year 1984, and 15% for taxable year 1985.

Dividends paid by Chilean corporations to resident individuals out of receipts not considered to be income which are exempt from the personal income tax are not subject to the individual income tax (global complementary tax).

(b) Stock dividends

Stock dividends representing the capitalization of profits or reserve funds are exempt from the personal income tax. The same exemption applies to refunds of capital when a corporation is liquidated.

(c) Profits of "personal" companies

Profits of partnerships, limited partnerships and limited liability companies must be included in the individual income of the partners, upon withdrawal or distribution.

These profits are therefore subject to first category tax in the hands of the entity and to individual income tax in the hands of the resident partners.

A credit of 10% of distributions made out of sums subject to first category tax is granted as from taxable year 1984.

3. Interest paid to resident individuals

(a) The concept of interest

Chile distinguishes between the appreciation derived from the indexation of loans and the effective capital income represented by interest. Consequently, in the definition of interest, it is necessary to differentiate between the nominal increase of the debt (simple restatement made to take account of changes in the consumer price index) and the interest itself (effective remuneration).

(b) Taxation of interest

Interest is subject to first category tax unless specifically exempt. First category tax is normally withheld at source.

Moreover, interest is included in the taxable income subject to individual income tax (global complementary tax).

(c) Exempt interest

Interest and similar income is exempt from first category tax if derived from:
- bonds, promissory notes and other credit documents issued on account, or with the guarantee of, the State or agencies thereof;
- bonds and mortgage bills issued by authorized institutions;
- bonds, debentures, bills, promissory notes and other credit documents issued by banking institutions of any kind, financial companies and certain cooperatives;
- bonds or debentures issued by stock corporations;
- saving shares (cuotas de ahorro) issued by cooperatives and capital contributions to cooperatives;
- deposits in pass books for housing;
- term deposits in Chilean or foreign currency and deposits of any kind with banking institutions, financial companies and certain cooperatives; and
- commercial documents (efectos de comercio) provided they are placed (intermediados) by a financial institution, an insurance company, a stock corporation or the stock exchange.

Note, however, that these exemptions do not apply when the interest is derived from a loan or financial transactions by business enterprises reporting their actual income on the basis of detailed financial records.

4. Royalties paid to resident individuals

Royalties paid to resident individuals are subject to first category tax (see III. above). Moreover, the royalty must be included in the taxable income subject to individual income tax (global complementary tax).

5. Service fees paid to resident individuals

Fees for independent personal services paid to resident individuals or to companies formed by professionals (sociedades de profesionales) are added to professional income and taxed under second category rules. However, second category tax on this kind of income is being phased out, to be fully eliminated as from taxable year

1985 (assessment year 1986). The fee must also be included in the taxable income of the individual income tax (impuesto global complementario).

6. Capital gains realized by resident individuals

Capital gains are subject to different tax regimes according to the person, activity and property which is involved. The different situations are:
(a) capital gains subject to normal income taxation;
(b) capital gains subject to special taxation; and
(c) capital gains exempt from income taxation.

(a) *Capital gains subject to normal income taxation*

Capital gains derived from habitual transactions are generally subject to normal income taxation (see II.F.5.).

In order to calculate the gain, the cost is normally deducted as adjusted for inflation in accordance with changes in the consumer price index during the period elapsing between acquisition and transfer.

(b) *Capital gains subject to special taxation*

Capital gains are subject to special taxation if derived from the transfer of:
- shares in stock corporations, provided the shares were acquired after 31 January 1984, the gain is not derived from habitual transactions, and the transfer occurs after one year as from acquisition;
- mines (pertenencias mineras), provided the gain is not derived from habitual transactions;
- water rights, provided the gain is not derived by taxpayers subject to the obligation to declare their actual income under first category rules or from habitual transactions;
- copyrights or industrial property transferred by the discoverer or author;
- shares and rights in a mining company other than a stock corporation, provided some conditions are met; and
- bonds, provided the gain is not derived from habitual transactions.

In order to compute the gain, the cost is normally deducted as adjusted for inflation in accordance with changes in the consumer price index during the period elapsing between acquisition and transfer.

The gains referred to are subject to a 10% final tax and must be reported in the month following that in which they arise.

(c) *Capital gains exempt from income taxation*

If the aggregate of capital gains subject to special taxation derived in a month by a person not subject to the obligation to report his actual income under first category rules does not exceed 10 monthly tax units, such gains are exempt from income taxation.

Capital gains are in any event fully exempt from income taxation if derived from:
- allocation of property to the heirs or to their "cessionnaries" (i.e. persons who acquire rights in an inheritance from an inheritor, e.g. by purchasing such rights from the inheritor) upon the division of an inheritance;
- allocation of property to one of the spouses or to their heirs or cessionnaries of any of them, upon termination of the joint property status of the spouses (sociedad conyugal);
- shares acquired before 31 January 1984, provided the gain is not derived from habitual transactions; and
- transfer of vehicles belonging to individuals and destined for the transportation of passengers or exclusively for the transportation of freight belonging to other persons, provided the owner does not have more than one of such vehicles.

7. Taxation of income from work

(a) *Employment income*

Employment income is subject to second category tax which is, in this case, withheld at source at progressive rates, that will be gradually reduced in the future as shown in Table 3.

Table 3

Taxable year 1983		Taxable year 1984	
Monthly income (tax units)	*Percentage to be applied on monthly income (per bracket)*	*Monthly income (tax units)*	*Percentage to be applied on monthly income (per bracket)*
— 10	—	— 10	—
10– 25	8	10– 25	7
25– 40	13	25– 40	12
40– 55	18	40– 55	17
55– 70	28	55– 70	27
70– 85	38	70– 85	37
85–100	48	85–100	47
100– —	58	100– —	57

Taxable year 1985		Taxable year 1986	
Monthly income (tax units)	*Percentage to be applied on monthly income (per bracket)*	*Monthly income (tax units)*	*Percentage to be applied on monthly income (per bracket)*
— 10	—	— 10	—
10– 25	6	10– 30	5
25– 40	11	30– 50	10
40– 55	16	50– 70	15
55– 70	26	70– 90	25
70– 85	36	90–120	35
85–100	46	120–150	45
100– —	56	150– —	50

Taxpayers may credit against their liability to second category tax arising from employment income:
- a personal credit of 10% of a monthly tax unit per month;
- a credit for each dependent of 10% of a monthly tax unit per month.

This tax is a final tax but, if the taxpayer has other income, employment income is included in the tax base of the individual income tax, with a credit for the tax already paid.

(b) *Income from independent work*

Income derived by individuals from the rendering of independent personal services is subject to second category tax. The rate is 7% up to taxable year 1983, 3.5% for taxable year 1984 and the tax is abolished as from taxable year 1985 (assessment year 1986).

A withholding tax or a prepayment creditable against the final liability is levied on the same income. For income derived from liberal professions (profesiones liberales) the rate is 15% up to taxable year 1983, 14% for taxable year 1984, 13% for taxable year 1985 and 10% as from taxable year 1986.

For income derived from other independent personal services, the rate is 10%. The same rate applies to income derived by companies (associations) created by professionals.

The income derived by individuals from the rendering of independent personal services is also included in the taxable income subject to the individual income tax discussed in IV.A. above.

(c) Directors' fees

Fees and participations in profits derived by members of boards of directors or advisory boards were subject to second category tax. The rate was 7% up to taxable year 1983 and the tax was revoked as from taxable year 1984 (assessment year 1985).

A withholding tax creditable against the final liability is levied on the same income. The rate is 15% up to taxable year 1983, and 10% as from taxable year 1984.

The income referred to is subject to the individual income tax discussed in IV.A.

(d) Expatriates

Non-resident individuals of foreign nationality who render technical, scientific, cultural or athletic services are subject to the tax on non-residents (additional tax) at a 20% rate. These persons are exempt from other income taxes.

Foreigners who come to live in Chile are subject to income taxes on Chilean-source income only, for a period of 3 years as from the date of their entry into the country. This period may be extended.

Pensions from foreign sources obtained by resident foreigners are not taxable.

V. TAXATION OF NON-RESIDENTS

A. General description

1. The concept of non-resident

In principle, a person shall be considered as non-resident if he does not have a domicile or a residence in Chile as discussed in II.C.2.

Legal entities and companies created under foreign law are treated as non-residents for tax purposes, even if they adjust their charter of incorporation to conform with Chilean law and if they establish their domicile in Chile.

2. General rules for the taxation of non-residents

Non-resident individuals and legal entities organized abroad, including those which have a permanent establishment in Chile (e.g. branches, local offices, agents or representatives), are subject, in addition to first category tax which may be due, to the income tax on non-residents (additional tax) on all Chilean-source income withdrawn or remitted abroad. A very important feature introduced by the reform of 1984 is the principle that the income tax on non-residents is levied upon withdrawals or remittances.

Income from Chilean sources is taxable in Chile even if derived by non-residents without an establishment or agency in Chile.

The income tax on non-residents is normally paid at a 40% rate and is withheld at source or subject to advance payments, either at the same 40% rate (general rule) or at a 20% rate.

The withholding on income withdrawn by, or remitted to, non-resident foreigners without a permanent establishment in Chile or to non-resident Chileans is made at 20% (where another rate is not provided for) but the final tax is charged at 40%.

A credit of 10% of chargeable sums previously subject to first category tax is granted in certain cases (i.e. dividends, branch profits and, in general, when the tax is assessed on an annual basis). Dividends receive the credits discussed in D.1.

B. Taxation of subsidiaries

Local subsidiaries of foreign companies are subject to first category tax under the normal rules.

However, in accordance with the Corporate Law, transactions between related companies (sociedades coligadas), between the parent company and a subsidiary or between subsidiaries of the same company must be made on an arm's length basis.

If the subsidiary is a stock corporation or partnership limited by shares, the after-tax profits are also subject to the tax on stock corporations. Note, however, that this tax is being phased out.

Dividends paid to the parent company are subject to the income tax on non-residents (additional tax) at a 40% rate withheld at source. A credit may be granted for taxes paid by the distributing entity under rules discussed in D.1. below.

C. Taxation of branches

1. Taxable amount

The amount of Chilean-source income of agencies, branches and other permanent establishments of foreign enterprises operating in Chile is established on the basis of the actual results obtained in Chile, i.e. on the basis of separate accounting records.

A system of estimation may be applied by the administration if the economic result of the branch's activities cannot be determined according to accounts. Taxable income may then be determined:

- by applying to the branch's gross receipts the same ratio which exists between the gross receipts and the net income of the parent company; or
- by applying to the branch's assets the ratio between gross assets and net income of the parent company.

The income determined by the application of such ratios is deemed to have been withdrawn from the enterprise and is therefore subject to the income tax on non-residents irrespective of actual withdrawal or remittance abroad.

2. Taxes which are applicable

The income derived by a permanent establishment of a foreign enterprise is subject to first category tax under normal rules. The income withdrawn from the establishment or remitted abroad is subject, upon the filing of the annual return, to the tax on non-residents (additional tax) at a 40% rate, but receives as from taxable year 1984 a credit of 10% of sums previously subject to first category tax. The tax on non-residents specifically applies to Chilean-source income of non-resident corporations, non-resident partnerships and non-resident foreign individuals having a permanent establishment of any kind in Chile, provided the income is withdrawn from the establishment or remitted abroad. For these purposes, a permanent establishment includes branches, offices, agencies and representatives. Moreover, the income withdrawn from the establishment or remitted abroad is subject, in addition to the normal advance payments, to a 40% prepayment which is creditable against the final tax; 10% of sums previously subject to the first category tax is creditable against this payment.

D. Taxation of particular items of income

1. Dividends paid to non-residents

Dividends distributed by Chilean stock corporations to non-resident taxpayers are subject to the income tax on non-residents (additional tax), withheld at source, at a rate of 40%. This tax is normally a final one: if the recipient, however, has a permanent establishment in Chile or is a Chilean citizen, the withholding tax is treated as a prepayment creditable against the final tax. A credit of 10% of dividends paid out of sums subject to first category tax is granted as from taxable year 1984. Shareholders can also credit against their liability a percentage of dividends paid out of sums subject to the tax on stock corporations (additional rate). This credit is 40% for taxable year 1983, 30% for taxable year 1984, and 15% for taxable year 1985.

Dividends paid by Chilean corporations to non-resident taxpayers out of receipts not considered to be income are exempt from the tax on non-residents (additional tax).

Stock dividends representing the capitalization of profits or reserve funds are exempt from tax. The same exemption applies to refunds of capital when a corporation is liquidated and to repatriation of capital which entered Chile under the Foreign Investment Statute.

Table 4

Up to	*Taxable year 1983*	*Taxable year 1984*	*Taxable year 1985*	*Taxable year 1986*
Gross dividend paid to a non-resident	100	100	100	100
Tax on non-residents "additional tax"	40	40	40	40
Credit for dividends paid out of sums subject to the first category tax	nil	10	10	10
Credits for dividends paid out of sums subject to the tax on stock corporations (additional tax)	40	30	15	nil
Balance of tax due to the Treasury	nil	nil	15	30
Net dividend	100	100	85	70

2. Interest paid to non-residents

Interest paid to non-residents is, in principle, subject to the tax on non-residents (additional tax) at a rate of 40% which is withheld at source. This tax is normally a final one: if the recipient, however, has a permanent establishment in Chile or is a Chilean citizen, the withholding tax is treated as a prepayment creditable against the final tax.

Note, however, that the following are exempt from the tax:

- interest paid to foreign or international banks and to foreign or international financing institutions approved by the Chilean Central Bank, in consideration of credits granted directly by them;
- interest on foreign currency bonds issued by Chilean companies, under the authorization of the Chilean Central Bank;
- interest on foreign currency bonds issued by the Chilean State, the Chilean Central Bank and the Agency for Production Development (Corporación de Fomento a la Producción);
- interest on Latin American Banking Acceptances (Aceptaciones Bancarias Latinoamericanas);
- interest paid for financing imports, if the financing has been authorized by the Chilean Central Bank; and
- interest paid on deposit accounts in foreign currency if the deposit is placed in an institution authorized by the Chilean Central Bank.

3. Royalties paid to non-residents

Royalties and any other consideration paid for the use of trademarks, patents and for know-how are liable to the 40% tax on non-residents (additional tax) on the gross amount, withheld at source. In principle, the tax is levied on the contract price, and no deductions are allowed.

This tax is normally a final one; if the recipient, however, has a permanent establishment in Chile or is a Chilean citizen, the withholding tax is treated as a prepayment creditable against the final tax.

Royalties which are unproductive or non-essential for the economic development of the country may be taxed at increased rates of up to 80%.

4. Service fees paid to non-residents

Service fees are subject to the income tax on non-residents (additional tax) at a 40% rate on the gross amount, withheld at source. In principle the tax is levied on the contract price, and no deductions are allowed.

This tax is normally a final one; if the recipient, however, has a permanent establishment in Chile or is a Chilean citizen, the withholding tax is treated as a prepayment creditable against the final tax.

Payments made to non-residents for services rendered abroad and consisting of engineering works or technical assistance are subject to additional tax at a 20% rate withheld at source.

Technical assistance which is unproductive or non-essential for the economic development of the country may be taxed at increased rates of up to 80%.

5. Capital gains realized by non-residents

If capital gains referred to in III.F.5. are derived by non-residents, the gain is subject to first category tax (see III.) and the income tax on non-residents (see V.A.2.).

Capital gains referred to in IV.B.6(b) are subject to the special taxation discussed therein, even if derived by non-residents.

Capital gains referred to in IV.B.6(c) are exempt from income taxation even if derived by non-residents.

6. Film and television payments to non-residents

Amounts remitted abroad to foreign producers and distributors as payment for film and television material are subject to the tax on non-residents (additional tax) at a 20% rate. The tax is withheld at source and is final.

7. Insurance premiums paid to non-residents

Insurance premiums paid to companies not established in Chile covering property permanently located in the country, merchandise which is in the country temporarily or for transit purposes, or the life of domiciliaries or residents are subject to the 40% tax on non-residents (additional tax) on the gross amount. This tax is withheld at source and is final.

8. Transportation payments to non-residents

Remuneration and commissions paid or credited to non-residents for sea transportation to or from Chilean ports and payments made to those persons for services which are necessary for the aforesaid transportation and which are rendered to boats or shipments are subject to income tax at a 5% rate. The tax is to be calculated on gross receipts and withheld at source.

Foreign enterprises with permanent establishments in Chile will be subject to the 5% tax but the tax, duly adjusted for inflation, may be credited against the final liability to the income tax. Any excess of credit is not refunded.

Exemption from the 5% tax is granted for ships from countries where no similar tax exists or where a similar exemption is granted to Chilean shipping enterprises.[3]

Payments made by Chilean navigation enterprises to non-residents can be exempt from taxation.

Under Decree-Law 2,564 of 22 June 1979, rents paid by a Chilean air company for the leasing of airplanes are exempt from the tax on non-residents (additional tax), provided some conditions are met.

VI. FINAL COMMENTS

The Chilean income tax reform contains, in the author's opinion, some very positive features.

The burden of income taxation is concentrated on that part of income available for consumption, while the charge on retained or reinvested income is greatly reduced. This change gives enterprises a greater capacity for saving and investment and may promote business activity.

Where the amount of income is presumed due to omission or defective reporting or for similar reasons, the income becomes fully taxable. This feature constitutes an important incentive to the correct reporting of income.

The elimination of taxes such as the tax on stock corporations, the tax on independent personal services (second category tax) and the housing tax (eliminated in a separate law) greatly simplifies the income taxation system.

On the other hand, some negative effects result from the reform.

Taxpayers placed in different positions as regards the possibilities of evasion were in the past taxed differently. Thus the taxation of business income, investment income and income from independent personal services was heavier than the taxation of income from dependent personal services. In recent years, the difference was attenuated and is now eliminated by the reform.

In theory it may seem unreasonable to use a higher rate for those taxpayers who are in a better position to evade and it seems unfair to assume that they will in fact take advantage of that possibility.

But experience shows that there are groups of taxpayers for whom it is much easier to evade and who actually do evade and groups for whom evasion is very difficult. If both groups are taxed under the same rules an injustice occurs, unless a substantial improvement in control methods is introduced; this improvement, however, cannot be expected in the near future, due to technical and financial limitations.

Under the new legislation, the income of non-residents is subject to a final tax of 40% (the effective rate may be lower), and, in the case of interest, such income is frequently exempt. The fact that most developed countries tax the world-wide income of non-residents at higher rates (45% or more) may result in a transfer of revenue from the Chilean Treasury to the Treasury of developed countries, without any benefit for non-resident investors. Needless to say, this transfer of revenue from a developing country to a developed country is completely unsound.

Finally, Chile has been reluctant to sign comprehensive double tax treaties, thus avoiding foreign interference with its taxation powers. However, if Chile considers the taxation of non-residents too heavy and should be reduced, it would seem more logical to try to obtain something in return for the reduction of its tax. This could be done through the negotiation of treaties, in particular with developed countries, instead of just reducing the tax burden unilaterally without asking for any compensation and even furthering the transfer of revenue to foreign Treasuries.

3. The Finance Ministry has declared that this condition is fulfilled as regards the following countries: Argentina, Austria, Bahamas, Belgium, Bermudas, Bolivia, Brazil, Canada, Colombia, Denmark, Dominican Republic, El Salvador, Finland, France, German Federal Republic, Greece, Guyana, Haiti, Hungary, Ireland, Israel, Italy, Ivory Coast, Japan, Liberia, Liechtenstein, Mexico, Netherlands, Netherlands Antilles, Nicaragua, Norway, Panama, Paraguay, Peru, Poland, Portugal, Saudi Arabia, South Korea, Spain, Sweden, Switzerland, United Kingdom, United States of America, Uruguay, Yugoslavia, and Zaire.

Transfer Price Adjustments and Double Taxation: A sword of Damocles for Multinationals

By Patrick L. Kelley

The Editors of the *Bulletin for International Fiscal Documentation* are indebted to the American Chamber of Commerce in Belgium for their permission to reproduce the Position Paper which was published in the June issue of *Commerce in Belgium.*

Flows of goods and services between affiliated companies belonging to the same multinational group are an ever growing feature of international economic life. The tax impact of intercompany transactions has become of greater concern in recent years, as tax authorities have shown a stronger tendency to challenge the "arm's length" basis of such transactions. In the U.K., for instance, the Inland Revenue has assessed 200 million pounds of additional profits since 1974 as a result of transfer price readjustments. For the United States, the total adjustments in 1980 and 1981 alone came to 4.4 billion dollars.

When tax authorities challenge transfer prices used in intercompany transactions, the consequences for a multinational group can be very serious. Such transfer pricing disputes often drag on many years, and require significant investments of manpower to attempt to demonstrate the arm's length nature of the prices involved. Most serious of all, however, is the potential for disagreement between two or more national tax authorities regarding the proper transfer prices. The mechanism for dispute resolution in such cases is often inadequate, and the resulting "double taxation" can be very costly.

Reflecting growing concern with the threat of double taxation arising from challenges to intercompany transfer pricing, the Chamber's Legal and Taxation Committee undertook an investigation of the problem at the request of the EC Committee. The focus of the study is on proposals of the European Community to resolve transfer pricing disputes and avoid double taxation.

Based on its study, the Committee prepared a Position Paper for the Council of American Chambers of Commerce – Europe and Mediterranean (EURO-MED). The text of this statement is set out below. Our Committee would welcome any comments and suggestions which Chamber Members may wish to offer regarding this important issue.

POSITION PAPER ON EEC PROPOSALS FOR ARBITRATION IN TRANSFER PRICING DISPUTES

The purpose of this paper is to state the position of the Council of American Chambers of Commerce – Europe and Mediterranean on certain proposals made by the European Economic Community to introduce compulsory arbitration procedures in cases where tax authorities are unable to agree upon proper transfer prices.* The Council warmly welcomes the initiatives taken by the Community authorities, and urges that prompt action be taken to realize these proposals. The reasons for this position are explained hereunder.

I. Increasing concern for double taxation arising from disagreement among tax authorities as to proper transfer prices

A common provision of bilateral tax treaties, as well as domestic tax legislation, gives tax authorities power to readjust transfer prices in transactions between related enterprises. If the adjustments made by tax authorities of one country are not compensated by appropriate adjustments in the country of the related enterprise, the consequence will often be that the same income is taxed in both countries. Given current prevailing rates of company taxation – roughly 50% – the resulting "double taxation" may result in a prohibitive total tax burden on profits resulting from the intercompany transactions.

The risk of double taxation arising from adjustments to transfer prices has increased in recent years within the EEC due to a variety of factors. One element is the progressive realization of the goal of free circulation of goods within the common market set up under the Treaty of Rome. A related factor is the increasing international division of labor which involves producing component parts in a number of different countries, for assembly into a finished good. Within the EEC, these two related factors have produced a steady increase in the transfer of goods and services across national boundaries among affiliated companies belonging to a single group. These international flows of goods and services among affiliated companies carry an ever growing risk of disagreement among national authorities as to proper transfer prices.

Another factor has undoubtedly been the difficult economic conditions of the last decade, which have reduced profits of enterprises in many industrial sectors throughout the EEC and elsewhere. The declining level of profits has made tax authorities more viligant to discover real or imagined transfers of profits to foreign affiliated companies.

Finally, one cannot ignore the introduction by the EEC in 1979 of coordinated procedures for exchange of information among tax authorities. These expanded proce-

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* Proposal for a Council Directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure) Official Journal C 301 4 of December 21, 1976.

dures for exchange of information may also have contributed toward more frequent challenges of transfer prices.

II. Difficulties multinational companies may encounter to prove compliance with the "arm's length" principle

The legal justification invoked by tax authorities in making adjustments to transfer prices is that affiliated companies have not respected the "arm's length" principle in dealings with one another. According to this principle, all commercial and financial transactions between related enterprises should be carried out at the same terms and conditions as would apply between unrelated persons.

Application of the "arm's length" principle involves comparisons of transactions among affiliated enterprises to transactions taking place between non-related enterprises. In practice, however, such comparisons are sometimes difficult to make with any degree of precision. This may be the case, for instance, where intercompany sales transactions involve component goods intended for assembly into final consumer products. There may simply be no sales of such goods to unrelated parties, either by the enterprise itself or by similar enterprises within the same industrial sector, with which to make comparisons.

Another practical problem in applying the "arm's length" principle is that affiliates may create contractual relations among each other for which parallels are difficult to find in dealings among independent enterprises. This results from the much higher degree of cooperation and assurance of long-term dealings which companies of the same group enjoy. An example of the kind of contractual arrangements which this close cooperation promotes is "long-term buy and supply agreements," recognized in the OECD 1979 study on transfer prices. Since unrelated enterprises seldom enter into such closely integrated arrangements, it may be difficult to prove that terms are at "arm's length."

Finally, problems also arise in judging transfer prices for such items as patent licenses and technological know-how, which are inherently difficult to evaluate and for which there may be no clear comparisons among unrelated parties.

The various reasons cited above which may create difficulties in proving compliance to the "arm's length" principle are reflected in the fact that authorities of different countries themselves may not agree as to the "correct" transfer price. It is such disagreement, and the double taxation which is likely to result therefrom, which is the focus of concern of this statement.

III. Inadequate provisions to avoid double taxation in existing bilateral double tax conventions

Between Member States of the European Economic Community, disagreements among tax authorities involving transfer prices are normally dealt with by a network of bilateral double tax conventions, generally based upon the OECD Model Double Tax Convention. These conventions are, unfortunately, not always adequate to resolve many problems posed by such disagreements. This is due to a number of significant shortcomings in their provisions.

A. Absence of a legal obligation to reach agreement

The first and most fundamental reason is that tax authorities who enter into negotiations (generally called the "competent authorities") are often not bound by such agreements to find a mutually acceptable transfer price which will avoid double taxation. Their obligation, as expressed in Article 25 of the OECD Model Convention, is merely to "endeavor" to find a common solution. There are cases where the authorities do not succeed in agreeing, with a resulting serious prejudice to the enterprises affected.

B. Economic double taxation often not covered

A second important reason for the current unsatisfactory state of affairs, is that most double tax conventions among EEC Member States provide for negotiations among competent authorities only in cases of so-called "legal" double taxation. That is, the authorities are only authorized to seek a common solution when the same legal entity is being taxed in both countries on the same profits. This leaves unprotected the far more common situation of "economic" double taxation, i.e. taxation of the same income in the hands of two separate but related enterprises.

C. Procedural shortcomings

Finally, existing double tax conventions are often deficient in procedures to guarantee adequate protection of the taxpayers' interests in cases where competent authorities attempt to agree upon a transfer price. The taxpayer is not a party to such "competent authority procedures." The enterprises directly concerned have therefore no legal right to introduce documents or other evidence, nor even to make known their views.

Also, the impact of statutes of limitations and the absence of interest on tax refunds may result in a denial of adequate protection, even when the competent authorities do agree upon a common transfer price.

IV. The unacceptability of double taxation

Double taxation is fundamentally unacceptable to enterprises. It creates a tax burden far in excess of that authorized by tax legislation, and often even in excess of the profits being taxed. This exorbitant burden is all the more unacceptable when the double taxation results through no fault of the taxpayer himself, but rather from the unwillingness or inability of tax authorities to agree among themselves.

Some tax authorities, however, apparently take the position that the threat of double taxation is positively desirable. According to them, this danger acts as a deterrent force to discourage multinational groups from attempting to shift profits among affiliated companies.

Such attitude must be firmly rejected. First, it overlooks the fact that rates of taxation are generally quite comparable within the European Community. There is consequently often little or nothing to be gained for a multinational group in shifting of profits, even if it were tempted to do so.

Secondly, the argument that the threat of double taxation serves to discourage shifting of profits ignores the practical difficulties which are often encountered in providing that transfer prices are at "arm's length." Indeed, if tax authorities themselves are unable to agree upon "correct" transfer prices, how can they expect enterprises to adopt prices which will be acceptable by all parties?

Finally, the argument in favor of tolerating the threat of double taxation overlooks the other legal remedies available, which are far more appropriate to this problem. First, the EEC has itself introduced measures for exchange of information, which give to national tax authorities a powerful arm to deal with the threat of profit shifting. Second, there are various penalties, both civil and criminal, available to tax authorities to deal with conscious attempts to understate income, e.g. by attempts to shift profits.

It may be argued that double taxation, although theoretically possible, is in practice normally avoided by tax authorities under existing arrangements through various ad hoc solutions. While it is difficult to find evidence to justify in how far this contention is valid, this argument nevertheless overlooks the substantial element of uncertainty which results currently from transfer price disputes.

Indeed, such disputes may take many years to resolve. During this time, the enterprise has no certainty as to its ultimate tax-burden. Considering the enormous amounts which may sometimes be at stake, such uncertainty is completely unacceptable to the enterprises, as well as to their shareholders and creditors.

V. An endorsement of action by the EEC

Concrete action by the European Communities is clearly appropriate to provide a solution to this serious problem. Indeed, it is a highly anomalous situation that within an integrated common market such as the EEC, there should be a complete absence of Community legislation in this area. The threat of double taxation undoubtedly represents an obstacle to the further development and integration of the internal Community market.

No one can ignore the undertaking originally made by the Commission in 1976, the year in which both the arbitration proposals and the proposals for exchange of information among tax administrations were originally introduced. At that time, the Commission gave assurances that the more energetic checking of transfer prices, made possible by improved exchange of information, would be compensated by a mechanism to insure against double taxation. This undertaking has yet to be fulfilled by the Community.

For all the reasons stated above, the Council of American Chambers of Commerce – Europe and Mediterranean officially endorses the adoption by the EEC of arbitration procedures to insure against double taxation where competent authorities are unable to agree upon transfer prices among affiliated companies in different countries. While the Council does not take a position on any specific texts, nevertheless it does urge the Community to move rapidly to adopt such procedures. The Community measures must guarantee prompt, effective and complete protection against double taxation to all enterprises established within the Community, irrespective of where their ultimate shareholders reside.

The U.S.S.R. 1984 Budget Act Revisited

The July 1984 issue of the *Bulletin for international fiscal documentation* published an article by Prof. Dr. Tibor Nagy which described the U.S.S.R. 1984 Budget and its relationship to the Soviet tax system. However, the problems involved are rather complex so that a further clarification is in order. At the same time, some printing errors are to be corrected.

1. On page 312 it was stated that foreign debts are never included in the budget calculations of the annual State Budgets. This is correct if it is understood that the U.S.S.R. Budget does not show any indebtedness to foreign States. However, loans to foreign countries (such as developing countries) are included unless they are considered to be gifts. The U.S.S.R. has on the other hand an indebtedness towards its own population through the issuance of State bonds, usually in the form of lottery bonds which give the holders a chance to win substantial prizes.

2. The total of the Budget in the Union Republics in Table 4 (page 312) "1984" is 161,936,562,000 rubles (and not 161,036,562,000 rubles).

3. The paragraph under Table 5 on page 313 should state that the taxes paid by the population in 1983 amounted to 29.7 million rubles (and not 289,700 million rubles).

4. In the next paragraph under the discussion of turnover taxes it was stated that more than 1,000 rates exist, but this figure should have been 10,000.

5. The 3 *headings* (b) *"Payments on assets"*, (c) *"Social insurance fees"* and (d) *Income tax* on page 313 should be changed to: (b) *"Taxes on profits"*, (c) *"Other taxes"*, and (d) *"Taxes on Cooperatives"*.

6. Also, in footnote 8 on page 313, the figure should be 335,200,000,000 and not 335,200,000 rubles.

7. Under *grants-in-aid* on page 314, the article of the law indicated should be "9(b)" and not "9".

8. The term State lottery used on page 314 denotes the revenue received by the State for lottery bonds issued (compare 1. above).

9. In the paragraph under the text of Art. 10 on page 315, it is stated that the report of the Council of Ministers will be adopted by a resolution of the Supreme Court. This should have been the Supreme *Soviet*.

Tax Changes in a Low Tax Country – The 1984-85 Budget in Bermuda

By H.W.T. Pepper

During his review of the Economy in his Ninth Budget Speech, the Hon. J.D. Gibbons, J.P., M.P., Minister of Finance, reminded Parliament that 1984 was the 375th Anniversary of the landing on the island by Admiral Sir George Somers, whose heart is still buried there.

1984-85 is also the fiscal year in which it is expected that Bermuda will become a "billion dollar economy", the GDP rising again by 2% to exceed $1,000,000,000. In addition, 1984-85 will mark the 10th year that Finance Minister the Hon. J.D. Gibbons will have been in office with an impeccable record of balanced budgets and an average annual 2% growth in the economy, despite periods of world depression in that decade.

Tourism, in total, achieved a healthy growth in 1983-84, and is scheduled for a 7% increase in 1984-85. Visitors from cruise ships have, however, decreased, although this may be only a temporary decline, because of re-arrangements of tour routes and take-overs within the cruise ship industry, because, on a world basis, ship cruises appear to be becoming more popular.

The trend in countries such as the U.S. and Britain towards heavier taxation of offshore operations is posing problems for overseas financial centres, but Bermuda with its extensive onshore operations actually achieved a net gain in the number of its international financial companies in 1983-84 and expects a modest gain in 1984-85.

Expenditure budgeted for 1984-85 includes increases for improving the cleanliness of roads, parks, and beaches, although Bermuda is already one of the cleanest and tidiest holiday resorts in the world! Other notable expenditure increases include substantial expansion of computer facilities in schools, which makes sense in a busy financial centre, and increases in state provision for housing and medical facilities for the public.

Mr. Pepper is a former tax inspector, and customs and excise officer in the U.K., advisor to various governments (Brazil, British Virgin Islands (B.V.I.), Gibraltar, Guyana, Jamaica, Malaysia, Malta, Solomon Islands, St. Kitts-Nevis, St. Vincent-Grenadines, Seychelle Islands, and Singapore.

No tax increases are scheduled on people doing business in, or tourists visiting, Bermuda, but "indexation" adjustments will apply to some specific duties. All duty is to be removed from life-saving apparatus and equipment for the disabled and elderly, while the duty on boats is to be materially reduced.

The increases in customs duties, as is traditional, took place as the Budget Speech was delivered. Increases in transport fares (buses and ferries) will, however, be embodied in a Bill to be introduced to Parliament by the Hon. Minister of Transport, because these "index" rises are not regarded as taxation.

In the year 2012, which is the 400th anniversary of the permanent settlement of Bermuda, the people will "inherit" $200 million from the present investment under Minister Gibbons' direction of a sum of $8 million in U.S. Treasury stripped zero bonds which will mature in 28 years' time.

This investment, which should, in due course, produce major social benefits for Bermudians, is clearly wisely timed at the present high level of interest rates, but only modest inflation rates, and, of course, Governments do not tax interest paid to other Governments. The investment is being made out of the Consolidated Fund, which currently, healthily, stands at $20 million, but upon which there will be other drawings of about $7 million during the current year.

BERMUDA:

Budget 1984-85

Extracts from the Budget Speech delivered on 24 February 1984 by the Honourable J.D. Gibbons, J.P., M.P., Minister of Finance.

REVENUE PROJECTIONS

The projections of revenue for 1984/85 are based on a number of assumptions.

(1) Regular tourist arrivals are assumed to grow by 7% in 1984/85. Cruise passenger arrivals, in contrast, are expected to fall from about 120,000 in the current year to about 100,000 in 1984/85.

(2) Although the number of international companies on the register increased last year by 4%, it has been assumed that there will be only a modest growth in the volume of expenditure in this sector in 1984/85. There was a sharp decline in this component of demand in 1982/83, and there is little evidence yet of renewed expansion.

(3) Domestically, real incomes should rise slightly in the absence of any upturn in inflation. Gross fixed investment seems set to continue at the high levels established in 1982 and 1983.

On the basis of these assumptions, I would expect real GDP to grow in 1984/85 by about 2%, similar to the rate achieved last year. With tax and fee rates unchanged, I would estimate this order of growth to generate total revenue of about $181.5 million. This includes the additional revenue stemming from an increase in the assumed level of annual remuneration per employee on which exempted companies are charged Hospital Levy. As foreshadowed in my Budget Statement last year, this amount is now indexed each year in April in line with the change in the retail price index in the year to the previous December. The new figure, effective from April of this year, will be $31,520. This increase will not affect payments made in April in respect of the January–March period, when the assumed level of annual remuneration is, as previously announced, $30,000. The first payments to reflect the increase to $31,520 will be due in July in respect of the April–June quarter.

The Minister of Transport will shortly be announcing increases in vehicle licence fees of about 10%, which will bring in an additional $550,000, but with the yield from some fees and taxes stagnant or in decline, a number of other increases are necessary in order to balance the Budget.

In proposing these changes, I have deliberately sought to avoid increasing fees or taxes which directly affect the cost of visiting or doing business in Bermuda. At this comparatively early stage in our economic recovery, I have no wish to blunt Bermuda's competitiveness either as a tourist resort or as an international financial centre. Instead, I propose to raise the additional revenue necessary by increasing customs duties, in particular on fuel products, thereby ensuring that the burden is spread as widely as possible throughout the Community. I will, accordingly, today lay before the House a Bill providing for the following increases in import duty:

On cigarettes, $2.50/kg;
On gasolene, 5c/litre;
On diesel fuel, other than supplied to BELCO, 5c a litre;
On fuel oil, other than supplied to BELCO, 5c a litre;
On diesel fuel, supplied to BELCO, 1.8c a litre;
On fuel oil, supplied to BELCO, 1.8c a litre.

These increases will take effect immediately.

The increase in duty on cigarettes is equivalent to about 5c a packet. The change should yield about $290,000 in the coming fiscal year.

The other increases all fall on petroleum products. The world oil market has remained weak throughout the past year, and oil prices in both nominal and real terms have declined. Indeed many observers expect further downward pressure on prices to emerge during the coming months, and OPEC members, many of whom are now in financial difficulties, will have to stick rigidly to their production quotas if prices are to hold. Looking to the longer-term, however, I believe it to be entirely appropriate that I should maintain or indeed increase the real price of energy in the face of declining costs on the world market. We in Bermuda have no energy resources of our own, and are totally dependent on imported fuel. The increases in duty I am proposing are designed to reinforce efforts to conserve energy and encourage a more responsible attitude to its use.

The price of gasolene has fallen in real terms by about 3% over the past twelve months. The increase of 5c a litre is more than is necessary to compensate for this, but I hope that it will encourage us all to adopt a more responsible attitude towards personal transport. Bermuda has excellent public transport facilities, and I would hope that this measure will lead to greater consideration of the bus and ferry services available. The increase is expected to yield an additional $1.6 million in 1984/85.

At the same time, I propose to increase the duty on diesel fuel, other than that supplied to BELCO, by the same amount, yielding $475,000 in a full year. I note, however, that the duty on diesel remains well below the duty on gasolene, and I recommend that in future Budgets steps should be taken to rectify, at least in part, this anomaly.

The increase in duty on fuel oil, other than that supplied to BELCO, will yield $520,000.

The duty on fuel purchased by BELCO has remained unchanged in the past three years, in order to contain the cost of electricity and assist our counter-inflation strategy. In the past twelve months, however, the average cost of electricity to the residential user has declined by over 2%; and even after my proposed increase of 1.8c a litre, the average consumer will, in real terms, pay less for his electricity this year than in 1983, assuming there are no unexpected increases in crude oil prices. I have, in any case, become convinced that the current arrangement whereby BELCO pays duty at the top rate of 33% on generating equipment, while paying a concessionary rate on fuel, is not in the best interests either of cash flow management or of energy efficiency. The duty on equipment is recovered via the basic charge for electricity and, given the structure of BELCO's tariff, the cost falls most heavily on customers who consume relatively small amounts of electricity. I propose, therefore, to abolish the duty on generating equipment while at the same time increasing the duty on BELCO's fuel imports. That way, the flow of duty payments will be smoother, benefitting both the Company and the Exchequer. In addition, the basic charge for electricity should fall while the higher duty payments on fuel will be reflected in the fuel adjustment charge. The reduction in BELCO's capital costs and borrowing should reduce their interest expense, benefitting all their customers; while the redistribution of the cost of electricity from low to high consumers should encourage energy conservation.

In increasing the duty on BELCO's fuel imports, there is one further consideration I have borne in mind. Government has agreed to assume responsibility for the street lighting of private estate roads, and installation is due to begin this year. In the absence of any equitable method of charging estate residents, Government has also agreed to bear the recurrent charges associated with private street lighting. It is intended that increases in duty on BELCO's fuel imports will cover these costs in 1984 and in subsequent years.

In total, the increase is expected to yield $2 million in 1984/85.

In addition to these revenue-raising measures, I have taken the opportunity to include a number of other amendments to the Customs Tariff Act. Most of these are minor, with negligible revenue implications. I propose, for example, to exempt from duty lifesaving resuscitators, and emergency response units used by the handicapped and the elderly; and the concessionary rate of duty that currently applies to T-shirts and gym shorts imported for the local business of screen printing will be extended to other items of clothing. I propose also to remove the duty on imports of milk, allowing imported milk to augment local production when supply falls short of demand. In order to protect the local dairy industry, however, it is intended that the Minister of Works, Housing, Agriculture and Fisheries should be empowered to embargo imports of milk whenever it appears that there is an adequate local supply available.

Mr. Speaker, one further change I am considering is a reduction in the effective rate of duty on boats which, other than for racing yachts which already attract a lower rate, stands at 33%. This high rate of duty might well have been appropriate in earlier years when the number of boats in Bermuda was much less than it is now, and there was little doubt that they were luxury items. In recent years, however, the number of boat owners has multiplied, and I have some sympathy for the argument that the sea is such an integral part of our environment that we should encourage as many people as possible to use it. There is the added incentive that, by increasing traffic on the water, we are reducing congestion on our roads. I will, therefore, be giving close consideration to a reduction in duty on boats in the near future.

I have also completed this year a review of the duty-free allowance for returning residents. The present allowance of $100 has remained effectively unchanged for over twenty years, and I recognise that there are many in the community who would welcome a higher figure. Against this, however, I have to weigh the loss of business to Bermuda resulting from an increase in the allowance, and the loss of revenue to Government. Nevertheless, I do feel that the balance of argument now supports a higher figure, and I accordingly propose that the allowance be increased to $250 with effect from 1st April 1984. This does not fully restore the real value of the allowance to its original level, but does nevertheless represent a substantial increase. The revenue implications are impossible to quantify, but the increase is likely to cost Government at least $400,000 annually in lost revenue.

With these changes, total revenue for 1984/85 is estimated at $186.5 million, an increase of 12% over the original estimate for 1983/84. Customs duty is the largest single source of receipts, accounting for $79.6 million, or 43% of the total. Revenue collected by the Tax Commissioner, principally from Hospital Levy, Employment Tax and Hotel Occupancy Tax, will produce $44 million. Receipts accruing to the Accountant General, including land tax, stamp duties and passenger tax, will amount to $24.2 million; while the Registrar of Companies will collect $12.5 million, mainly from international and local company taxes and insurance fees.

Mr. Speaker, I began today by referring to the improved economic climate both at home and abroad since my last Budget. Outside North America, however, the economic recovery remains subdued, and in the United States itself there are fears that the vigorous expansion of 1983 might not continue much beyond this year. While I believe, nevertheless, that we in Bermuda can look forward with some optimism to the coming year, let me sound a note of caution. The past three years have been difficult, in marked contrast to the five years of rapid growth in the period 1975-1980. Although the prospects this year look better, we can no longer assume that economic success is assured. It behoves us all to redouble our efforts to ensure that, in a highly competitive world, Bermuda continues to pay its way.

Mr. Speaker, I respectfully submit the Budget for 1984/85, the ninth time I have had the privilege of so doing.

ISRAEL:

No Major Changes in Taxation in the Budget 1984-85

By Dr. J.F.Pick

According to Treasury calculations, taxation amounted in 1983/4 to 46.4% of the Gross National Product – close to the top level reached in other countries and certainly close to the limit of taxing capacity. Therefore, the Budget put before the Knesseth by the Minister of Finance on 22 February 1984 does not project an increase in tax revenue but a small decline (in real terms).

In view of the urgent need of a cut in the deficit which is partly covered by the printing press – the main cause of 400% annual inflation in Israel – the main efforts of the 1984/5 budget have been in the direction of a reduction of expenditure, including painful cuts in the budgets for defence, health, welfare, education and, in general, administration.

As can be seen from Table I, the Government expects a 5% decline in tax collections in 1984/5 following a similar decline in 1983/4. This decline is expected despite some revenue-increasing changes in the tax law, details of which are given in Table II.

The main items of additional tax income are derived from changes in technical provisions of the tax laws and methods of tax collection rather than from increases of tax rates, which can hardly be further increased. When the effect of changes in the tax law is eliminated, tax revenue is expected to be about 10% below 1983/4 and about 16% below 1982/3.

The figures (in Israeli Shequel or IS) given in this review are based on the estimated price level in the first quarter of 1984/5 (April-June) which has been used in the presentation of the budget (slightly less than 200 IS for US$ 1). Unless otherwise indicated, all figures given here are based on those values.

The problems of expressing a budget in definite and comparable figures in a period of 400% annual inflation with most prices, costs, wages and investment yields moving in line with the cost of living index or the exchange rate of the U.S. dollar – but with differences in detail, methods of calculation and speed of adjustment – involve complicated questions, which will not be discussed in this review.

The expected overall decline in tax income despite some revenue-raising changes in the tax laws can largely be explained by three developments:

(1) The expected economic slowdown which is likely to affect adversely profits and the consumption of highly taxed products, especially durable consumer goods.

(2) The decline of income tax collections from the business sector following the introduction in 1982 of an inflation-adjusted tax base. This decline seems to indicate that tax savings from the capital maintenance allowance on the holding of erosible assets by firms exceeded by far the increases of the tax burden due to taxation of the inflationary gain from indebtedness. Furthermore, the very complicated provisions of the new tax law led to delay in the submission of tax returns and of tax payments.

(3) Despite the vast experience of Israeli authorities with life under inflationary conditions, the provisions regulating tax payment dates and the addition of interest and linkage on tax debts did not always keep pace with inflation. While the tax law has been amended in this respect (see below), at the time of writing this review there is still a strong incentive for delaying advance tax payments for the current tax year, which carry a penalty of only 1.5% per week. This may, however, be changed at a later date.

As can be seen from Table I, most of the decline in tax revenue from 1982/3 to 1984/5 (estimate) is accounted for by the Income Tax Department, while the Customs and Excise Department over the 2-year period suffered almost no decline. In fact, the discontinuation of the compulsory loan (a percentage of the income liable to tax) introduced in 1982, the very sharp decline in the yield from the sales tax on quoted securities between the stock exchange boom year 1982 and the present period of an almost dormant stock exchange and the above-average decline of tax income from the business sector explain between them roughly the whole reduction of tax revenue in the 2-year period. Revenue from income tax from employment is expected to maintain in 1984 the 1982 level.

As already indicated, there have only been a few increases of tax rates in 1984 but some steps have been taken to remove tax exemptions or to correct distortions.

One of these steps has been a revision of allocations of payments between interest and principal. Amendment 59 to the Income Tax Law, published one day after the presentation of the budget, changes the method of allocation of tax payment between the original tax debt and interest. Because the adjustment of tax debts for the decline in the value of money has been more complete than the adjustment of the interest on the tax debt, the new method of allocation which removes the old rule "first principal, thereafter interest" is likely to increase collections.

Amendment 59 also replaces the rule that tax debts are charged with interest during the first 6 months and thereafter with the higher of interest and linkage according to the cost of living index (plus 4% unlinked interest). It provides for charging the higher of the two for the whole period. That change, too, should considerably increase tax collections because the present rate of the interest charge (13% per month flat – no compound interest) is

We sadly announce that when this article went to press we were informed that on 17 August 1984 Dr. Pick passed away. His untimely death prevented him from completing the many tasks he had imposed on himself, and the International Bureau of Fiscal Documentation mourns a fine scholar and a good friend. **Dr. Pick** was a partner of Pick, Cohn & Co., Certified Accountants, Tel Aviv, Israel.

even in case of debts of only one month below the rate of inflation.

The summary in Table II shows an increase of tax revenue due to the disallowance of the set-off of tax losses from stock exchange transactions against profits not derived from the stock exchange. That provision, which is also referred to in the Budget Speech, is not included in amendment 3 to the law for inflation-adjusted taxation of business profits of April 1984. Stock exchange profits have been tax exempt in Israel until the above-mentioned law introduced taxation of gains from quoted securities which are part of business accounts in as far as they are "real profits", i.e. after deduction of the inflationary element of the nominal profit. Stock exchange profits from private investment are still exempt.

When inflation-adjusted taxation of business profits was introduced in August 1982 (the date of the publication of the law, effective from tax year 1982 onwards), the Tel-Aviv stock exchange was booming and there was an expectation that the provisions concerning profits from quoted securities would bring in large amounts of income tax. However, the boom broke down completely in January 1983 and the boom in bank shares in October 1983. If the proposed limitation of the set-off of stock exchange losses does not come into force, stock exchange losses of the tax years 1982 and 1983 will considerably reduce tax collections. (Taxation of stock exchange profits is based on quoted values at balance sheet date, i.e. includes imputed profits.) Another source of improved tax collections is expected from the removal of various tax exemptions.

In Israel there is no tax credit for children, but the National Insurance Institute pays child allowances at graduated rates instead, a small allowance for the first and second child, but larger allowances from the third child onward. These child allowances have been tax exempt, but beginning with the year 1984 parents of not more than 3 children reaching the 50% tax bracket (reached at an annual income of the equivalent of about $10,000) are losing that tax exemption for the first two children.

There is a tax exemption of 35% of pensions received by retired persons. That exemption has now been removed in respect of certain cases where the recipient of the pension earns income from a business, profession or employment.

Further restrictions of the partial exemptions of pensions and abolition of the tax exemption of old age benefits from the National Insurance Institute have been under discussion, but have been turned down.

Two increases of tax rates have taken effect, but are not expected to bring in very large amounts. A temporary levy is being added to income tax on that part of the annual income which exceeds the equivalent of approximately $40,000. That levy adds 10% to the 60% top tax rate (raising it to 66%) for the whole year 1984 and for one sixth of the income of 1983.

The maximum rate of personal income tax has been reduced to 60% by the tax reform of 1973 in order to remove a disincentive to work. There has always been reluctance to exceed the 60% rate and the above-mentioned increase is being limited to a restricted period of 14 months.

In March 1983 a levy on foreign travel was introduced, adjusted from time to time to the equivalent of about $50. For the tax year 1984 the tax has been increased by 100% (US$ equivalent).

The expected addition to VAT collections indicated in Table II is based on monthly (instead of bi-monthly) reporting and payment of that tax. In March 1985 amounts of VAT will be collected which in case of a continuation of the bi-monthly system would be collected in tax year 1985/6 (April 1985). As a matter of fact, the benefit of increased collections in March 1985 will be lost in April 1985.

On the other hand, at the rate of the current hyperinflation in Israel, the collection of VAT on the average of half a month earlier – because of monthly collection – will mean a benefit for the Treasury because the value of the money collected during a full year will be higher by half a month's inflation (at present rates, about 7%). The rate of VAT in Israel which applies to almost all goods and services is 15%.

In view of the details given herein it would appear that taxation in the 1984/5 budget will not introduce major changes. The reduction of income tax collections from the business sector in 1983, due to the introduction of the law for inflation-adjusted taxation of business profits will continue in 1984. Whether that is due to delays in tax collection or to the provisions of that law or to both, the share of corporate profits and other business income in tax collections in Israel declined following the enactment of that law. Amendment 3 of April 1984 added more complications to the already overcomplicated law, but did not change its general effect.

There is a consensus in Israel that, in view of its complicated provisions, the inflation adjustment law has to be basically changed.

There appears also to be a certain trend to revise that law because of its effect on tax collections. In view of the strong inclination among businesses in Israel, before the inflation adjusted tax law was introduced, to work with as little own funds as possible, the loss of tax income due to that law – which gives tax relief for the erosion of own funds but collects tax on the profits from financing with borrowed funds – appears somewhat surprising. Possibly the decline of tax income is mainly due to delays in tax payments and to set-off of stock exchange losses against other income.

The main problem of the 1984/5 budget lies outside the field of taxation. The 4,360 billion IS on the expenditure side include more than 900 billion IS interest and more than 1,300 billion IS debt repayment (including the Bank of Israel). Against this there are on the income side over 600 billion IS foreign loans and grants, 1,800 billion IS local loans and financing and 250 billion IS to be covered by the printing press.

Though these figures give a somewhat exaggerated view, because a very large part of the debt repayment (even including interest) to institutions and the Bank of Israel will automatically be returned as new lending, they nevertheless indicate that the availability of private sector savings for lending to the Government will be not less important than fluctuations in the tax income.

For a very long period, index-linked Government Bonds and similarly linked saving accounts, invested by the banks in Government paper, formed the main outlet for the considerable savings of the non-Government sector in the Israel economy and at the same time an important source of Government income. Following the large rise in Government liabilities, partly in the wake of the bank share crisis and the jump in the rate of inflation in autumn 1983, the Israeli public became much more reluctant vis-à-vis that type of saving.

It would therefore appear that the restriction of the printing press to the 250 billion IS foreseen in the budget will depend to a large part on the continued readiness of the Israeli public to save in Government paper.

The elections on 23 July will make the achievement of the economic targets even more difficult and leave the unpopular economic measures required for improving the state of the economy to the new Government.

Table I
Estimated tax income in the 1984/5 budget at prices of April-June 1984
(in billion Israel Shequel)

		% of change		% of total		
	Estimate 1984/5	*1984/5 against 1983/4*	*1983/4 against 1982/3*	*1984/85*	*1983/84*	*1982/83*
Total tax income	1,575*	(5.1)	(5.5)			
Income tax department	883	(5.9)	(11.4)	56.1	56.8	60.6
Customs & Excise Dept. (inc. import deposit)	677	(4.6)	3.5	42.9	42.5	38.6
Other departments	15	30.2	(15.3)	1.0	0.7	0.8
Income tax department						
Income tax from business sector	404	(4.5)				
Income tax from employment	324	(2.9)				
Property tax	30	(7.1)				
2% Sales tax on quoted securities	27	(24.9)				
Employers tax	48	(4.8)				
Other income of department	50	(4.8)				
Customs & Excise Department						
Customs duty	64	(2.8)				
Purchase tax	145	(–)				
VAT	331	(6.3)				
Import levy & foreign currency purchase tax	41	(9.1)				
Fuel tax	38	7.7				
Excise on tobacco	14	2.4				
Stamp duty	9	(4.8)				
Foreign travel levy	8	69				
Import deposits	27	(19.7)	– deposit of 15% of the value of certain imports – refunded unlinked after 12 months			

* The small differences between the amount and that quoted in the budget speech is caused by the omission of VAT on Defence Ministry imports.

Table II
Addition to the budget estimates for 1984/85 due to changes in tax legislation
(in million IS).

Restriction of the benefits on withdrawals from supplementary studies-funds	460
Restriction of tax benefits on early retirement pensions	460
Changes in allocation between principal and interest	
(a) income tax	23,000
(b) VAT	6,900
Addition to income tax on high incomes	5,750
Taxation of children allowances in certain cases	6,900
Monthly collection of VAT	13,800
Increase of foreign travel levy	3,900
Proposed change of section 20 of inflation tax law (set-off of losses from quoted securities against profits from such securities only)	34,500
	95,670

Against this, the compulsory loan collected in part of the tax years 1982/83 and 1983/84 which yielded in 1982/83 about 75-80 billion IS and in 1983 about 15 billion IS (in terms of the money of April-June 1984) has been abolished.

Addition to tax collections in 1983/84 because of changes in tax legislation

	IS million *
Foreign travel levy	2,135**
Foreign currency purchase tax	7,854
Increase of 10% (of the value of the goods) in purchase tax rates	9,000
Import deposits	14,548
	33,537

* The amounts are given in current values of tax year 1983/84. 1 IS in 1983/84 is worth, on the average, about 2.30 IS in April-June 1984.
** The foreign travel levy was introduced in March 1983 and a very small amount of tax was already collected in tax year 1982/83.

ISRAEL:

Budget 1984-85

Extracts from the Budget Speech of Mr. Cohen-Orgad, Minister of Finance, on 22 February 1984.

In the terms of the 1984 Budget the estimate of income from taxes is 1,607.3 billion Shequel. That means in real terms a reduction of 5.1%.

That reduction is the result of the economic policy practiced in the second half of tax year 1983. That policy caused the decline of consumption and imports, especially import of goods subject to high taxes and a recession in the economic activities for local consumption. All those are leading to a continued downward trend in tax collections (in real terms).

To these influences the discontinuation of the collection of the "Peace for Galilee" loan after August 1983 should be added, the law for taxation under inflationary conditions and especially the possibility of setting off losses from declining values of quoted securities against income from any other source led to a considerable reduction of the income subject to tax in the business sector.

Against the above-mentioned factors, which led to a considerable reduction in the estimated tax income, there will be some increases of tax income following changes in the tax law lately approved by the Knesseth (the Israeli Parliament). Doubling the levy on foreign travel, monthly instead of bi-monthly VAT returns and payment, increase of the marginal tax rate on high personal incomes from 60% to 66%, abolishment of the tax exemption of the child allowance for the first two children for families with not more than three children, the marginal tax rate of which is at least 50%, abolition of the tax exemption of 35% on pensions in case of early retirement for taxpayers with other income from business, profession or employment.

All these measures will not only increase Government income but shall also lead to a more equitable distribution of the tax burden and shall also remove distortions caused by inflation.

I shall now briefly review developments in the field of taxation in the recent year.

During the first months of the year 1983/4 relative prosperity prevailed in consumption, import and economic activity. During the last months of the year the trend was, however, reversed and the economy entered a phase of a slow-down in its activity.

Naturally, that trend found expression in the income from direct and indirect taxes. As against a rise in tax income – in real terms – in the period April-August 1983, compared with that period in the proceeding year, from September onwards a gradual decline of tax income started, a trend reinforced in the last months of the tax year by considerable reduction of the import of products subject to high tax rates, in consequence of an economic policy of restraint.

The rise of the income of the customs department in the period April-November 1983 compared with these months in 1982 had two reasons: the increase of the import of goods subject to high rates of indirect taxes and the increase of these tax rates. These tax increases and especially increases of taxes on imports have mainly been caused by a change in the effective exchange rate on the import of goods and services. It found expression in some steps taken in June 1983: a 1% levy on the acquisition of foreign currency, a compulsory import deposit of 15% of the value of the imported goods and a travel levy amounting in Israeli currency to the countervalue of about $50.–, which levy as already mentioned, it is proposed to increase twofold.

The prevailing purchase tax rates have been increased by 10% in August 1983. The Tax levied on most consumer goods, a large part of them durable consumer goods. Against this the import levy has been reduced in June 1983 from 3% to 2%. The change in tax rates led to an increase in the tax collections by the customs department up to December 1983. From that month onward the income from indirect taxes declined because the decrease in imports more than set off the increase in tax rates.

As already mentioned the income tax department terminated the collection of the Peace for Galilee (compulsory) loan, reducing tax collection in addition to reduced economic activity and sharply reduced collections of the sales tax on quoted securities.

In the financial year 1983/4 there were also changes in the income tax field. In June 1983 the tax on oversubscriptions of new issues has been abolished. The rate of tax deduction at source on payment of writers' and lecturers' fees, on extra work and on interest on foreign currency amounts at banks have been increased in October 1983 from 40% to 45%. Furthermore tax relief on investments in research and development has been introduced.

As I already mentioned the expected decline in tax income in 1984 amounts in real terms to 5.1%. We shall have to improve tax collection from corporations and selfemployed taxpayers by way of new laws, which have recently been approved, among them "apportionment of payments" and monthly reporting of VAT.

We intend to re-examine the law for taxation under inflationary conditions, which expires at the end of tax year 1984. The implementation of the law is very costly, for the tax administration and for the business community, on top of the reduction of tax collection from business income caused by its provisions.

We are examining the present system and alternative proposals with the aim to reduce tax rates, to simplify tax laws, to make the mutual use of assessments of the two main taxes possible – income tax and VAT – all that without a reduction of the collections from the business sector. I have no doubt that the realisation of these aims will reduce the bureaucratic burden on tax payers and make the work of the tax administration efficient.

In the effort to improve the tax administration, to deepen the assessment and to reinforce the deterrents we shall carry out a number of organisational and administrative changes which will lead to a better use of our existing facilities. For that purpose we shall merge the investigation departments of the various tax branches, we shall benefit from the larger rise of the units of assessment and collection.

It will be possible to obtain such benefits through improved coordination between the two main taxes – income tax and VAT.

BANGLADESH:

The New Draft Income Tax Ordinance

Some Observations

By K.A. Gofran

We very sincerely welcomed the declaration of the Honorable Finance Minister before the Nation at the time he presented the Budget for 1983-84, in which he stated that a new Income Tax Ordinance would be promulgated by January 1984.[1] At that time, however, the reason for promulgating the Ordinance in January 1984 was not immediately clear to us in view of the fact that the current Income Tax Act, 1922 (as amended) and the new Ordinance would both apply to the same assessment year (1983-84) and such a simultaneous operation does not seem to be possible. Nevertheless, we felt very happy at the Government's decision to abolish the old Income Tax Act, 1922, which, in spite of yearly tinkering and grafting to suit and to cope with the exigencies of circumstances, seems to have failed – in some respects – in meeting the challenges and solving the problems presented by a changing society. At this moment both India and Pakistan have replaced the old Act of 1922 (which was introduced by the British and applicable in most of the sub-continent) with the Act of 1961 and the Ordinance of 1969, respectively. The decision of the Bangladesh Government, therefore, deserves our unqualified praise.

Reliable sources have indicated that the original draft Income Tax Ordinance, which was completed in 1982, contained a great number of serious mistakes so that another draft – mainly patterned on the first one – was hurriedly prepared, correcting as far as possible the mistakes of the earlier draft. The latest version, known as the draft Income Tax Ordinance, 1983, is reportedly being subjected to the final scrutiny of the National Board of Revenue. It has also been reported that prior to the present examination the draft was carefully checked by two Working Groups, one representing the Board and the other the public sector. The final report of the Joint Working Group – which attempted to strike a balance between the opinions of the two Working Groups and to narrow down the areas of difference – is now being examined at Board level.

In this connection we would like to point out that in our opinion there are still some defects in the draft which should be taken care of before it is promulgated as an Ordinance.

EXPENSES AND ALLOWANCES

To start with, the scheduling and structuring of expenses and allowances is not logical, which may lead to unhappy results. In particular, the deductions for expenses relating to salaries, interest on securities, income from property, agricultural income, business income, capital gains and income from other sources have been changed and incorporated in the Second Schedule to the Ordinance, thereby making a departure from the past and creating a deviation from the current Indian and Pakistani legislation. This new arrangement of removing the provisions for expenses and allowances from the body of the Act and putting them in a Schedule will cause inconvenience to anyone who wishes to apply the law. We suggest, therefore, that these items be shown immediately after the respective heads.

EXEMPTIONS

The First Schedule of the draft Income Tax Ordinance roughly corresponds to Section 4(3) of the present Act dealing with income excluded from the scope of income tax. However, exempt income derived by industrial enterprises benefitting from the tax holiday provisions in Bangladesh's Income Tax Law has also been placed in the First Schedule. We believe that placing income which falls outside the scope of the Income Tax Law and exempt income in the same category is not very logical. The purpose of the present Section 4(3) is to enumerate income not to be taken into account in the taxpayer's total income. In the case of industrial enterprises enjoying tax holiday relief, however, total income must be computed in the normal manner as prescribed by Section 10 of the present Act with the sole exception that initial depreciation may not be taken. In addition, an enterprise enjoying tax holiday relief has to meet certain legal requirements *after* it has been granted the tax holiday which are quite distinct and separate from the conditions which a company must fulfill to obtain the tax holiday. The Income Tax Department must at the time of the computation of total income for purposes of income tax assessment check whether these obligations have been met; if only one condition has not been complied with, the benefit of the tax holiday for that year may be withdrawn, thereby requiring the enterprise to pay tax in that year for income which would otherwise have been exempt. It is for the above reasons that the income derived by a "tax holiday enterprise" should not have been placed together with income items which are completely exempt and which also do not form part of the taxpayer's total income.

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1. See 37 *Bulletin for international fiscal documentation* 11 (1983) at 514.

COMPUTATION OF TAX HOLIDAY INCOME

The draft Ordinance suffers from another defect in that, although it imposes the obligation on the enterprise to reach a certain degree of profitability (expressed as the ratio between profit and invested capital), it does not provide for a proper definition of profits. In other words, it is not clear how the enterprise must compute its profits and whether it may deduct the expenses listed in the Schedule or not.

DIVIDENDS DISTRIBUTED FROM TAX HOLIDAY INCOME

The most serious defect in the new legislation concerns the treatment of dividends distributed by companies which benefit from the tax holiday exemption. In order to understand the problem at hand we will first discuss the history of the pertinent provisions. At the time when Bangladesh formed part of Pakistan, the Tax Holiday Scheme was introduced under Section 15BB of the Income Tax Act, 1922. The Pakistani tax authorities were of the opinion that although the income derived by the tax holiday company was exempt, this was not the case with dividends distributed from the exempt income. In other words, the tax authorities assessed the dividends thus distributed to income tax in the hands of the shareholders. This practice was continued by the Bangladesh tax authorities after Bangladesh separated from Pakistan in 1971. However, the shareholders did not acquiesce in this situation and went to court so that ultimately the Bangladesh Supreme Court (Appellate Division) had to pronounce itself on this issue. The Supreme Court, relying on an earlier decision rendered by the Supreme Court of Pakistan (Mrs. Millers v. C.I.T.), held that the wording of the law at that time did not permit the tax authorities to impose tax on dividends distributed out of profits exempt from income tax by virtue of the tax holiday provisions.

The tax authorities, finding no other way to tax such dividends, persuaded the Government to insert the following provision in the Income Tax Act, 1922:

> (2E) Nothing contained in this section shall be deemed to exempt from tax any dividend credited or distributed or deemed to have been paid, credited or distributed by a company to its shareholders out of the profit or gains exempt from tax under this section.

We have had the opportunity to urge the Government on several occasions in our tax journal to delete this provision. In those instances, we have observed that the very purpose of the tax holiday would be frustrated if the shareholders were made to pay tax by creating a legal fiction, and that this would greatly retard the pace of industrialization of the country – which is the express purpose of the Government. We firmly believe in the principle stated by the Supreme Court of Pakistan that the mere fact that income has changed in category does not mean that it has changed its character. However, up to now, the Government has not heeded our arguments.

But the effect which the draft Income Tax Ordinance will produce is even more onerous than the present law provision, although it seems that the legislature is not aware of this situation. The road to hell – from the taxpayer's point of view – is indeed paved with the best of intentions. As stated above, the Government wished to tax the dividend, distributed from the exempt profit derived by tax holiday companies, and to circumvent the decision of the Bangladesh Supreme Court it included an express provision in the Income Tax Act, 1922. A storm of protest arose from all quarters against this procedure, and *Bangladesh Tax Decisions* joined in this opposition. However, the Government did not budge from its stand until the new Income Tax Ordinance was drafted. It seems likely that this draft aimed at removing this effect, which is generally considered to be a veritable stumbling block on the way to rapid industrialization of the country. For this the following *Explanation I* was introduced in item 24 of the Second Schedule:

> Explanation I. For the purpose of benefit under this item the following shall be excluded from the income derived from the industrial undertraking, namely:
> (a) such amount as is, or is deemed to be, paid, credited or distributed as dividend to the shareholders of the company, and
> (b) the amount of any income classifiable as "VI - Capital Gains relatable to the industrial undertaking".

This seemingly innocuous provision will not have any sinister meaning to many of the readers of the law unless they subject it to thorough scrutiny. The title of the Schedule under which item 24 appears is: "*Income excluded from the purview of the ordinance*". Its meaning is clear and no ambiguities can be detected, i.e. it means that the 25 items included in the Schedule will be excluded from the taxpayer's total income. Accordingly, any profit listed in the Schedule derived by an enterprise which meets the conditions listed in the Schedule, and which has received the appropriate Government authorization, is exempt from tax. The purpose of *Explanation I,* as reproduced above, is to exclude dividends distributed by such an enterprise to its shareholders from the list. This exclusion will, therefore, result in the imposition of tax on dividends distributed by tax holiday companies.

The situation is even worse if one reads (a) in *Explanation I* in conjunction with (b) in the same *Explanation*. In (b), capital gains arising from a sale, exchange, or transfer of any capital asset belonging to the tax holiday company are made taxable in the hands of such company by its exclusion from the scope of the Schedule. By analogy, profits which are distributed as dividends by a tax holiday company will also be taxable. The effect of the proposed *Explanation I* will be most detrimental to the Interests of taxpayers since it will harm them in two different ways:

(a) First, shareholders will be required to pay tax on dividends distributed out of (exempt) profits of tax holiday companies.
(b) Secondly, the tax holiday company will be required to pay tax on that portion of the exempted income which it distributed as a dividend. This will force the company not to declare any dividend and, consequently, investment in tax holiday companies will be discouraged.

In conclusion, the new legislation will very adversely affect the investment climate of the country and the process of industrialization will be greatly retarded.

New Definition of United States Tax Residency

By W. Scott Thomas

Mr. Thomas is a tax partner in the California law firm of Brobeck, Phleger & Harrison. He is also the United States correspondent for the *Bulletin*.

United States citizens are subject to United States tax on their world-wide income, regardless of where they reside. Non-citizens who reside in the United States are also subject to tax on their world-wide income. However, non-citizens who do not reside in the United States are subject to tax only on their United States-source income. Thus, residency is an important tax concept for non-citizens.

The Tax Reform Act of 1984, recently signed into law, provides a new statutory test to determine residency. After 1984, a non-citizen will be treated as a United States resident if either (1) he is a lawful permanent resident of the United States (the "green card test"), or (2) the sum of (a) the days present during the current year, (b) one third times the days present during the preceding year, and (c) one sixth times the days present during the second preceding year equals or exceeds 183 (the "substantial presence test").

The substantial presence test will not count days of diplomats or certain other representatives of foreign governments (indefinitely), teachers or trainees (generally for 2 years only), or students (generally for 5 years only). The test will not apply to an individual who is unable to leave the United States because of a medical condition that arose while he or she was present in the United States.

There is an exception to the substantial presence test for individuals present for fewer than 183 days during the year who establish closer connections with a foreign country than with the United States and a tax home there for the year. This closer connections/tax home exception will not be available for any applicant for an immigrant visa.

If an individual is a resident of the United States for 3 consecutive years under the new statutory definition and is a resident of the United States during one of the next 3 years, then he or she will be subject to United States tax for all intermediate years on the same items of income that would be taxed to a U.S. citizen who renounced United States citizenship for the principal purpose of avoiding United States tax. This rule will apply regardless of the subjective intent of the non-citizen.

These new rules do not override treaty obligations of the United States. For example, a non-citizen who is a resident of the United States under the new statutory definition but who is a resident of a treaty partner of the United States (and not a resident of the United States) under an income tax treaty will be eligible for the benefits that the treaty extends to residents of the treaty partner. However, notwithstanding the treatment of the non-citizen as a resident of the other country for treaty purposes, the new rules will treat the non-citizen as a United States resident for purposes of the internal tax laws of the United States. For example, if the non-citizen owns more than 50% of the voting power of a foreign corporation, the foreign corporation will be a controlled corporation.

International Chamber of Commerce:

The Resolution of International Tax Conflicts

Statement adopted on 16 June 1984 by the Commission on Taxation for submission to the ICC Council at its 146th Session in Stockholm[1]

I. THE BACKGROUND

The development of trade and capital investments between the nations of the world depends to a large extent on feasible solutions to the problem of double taxation. The number of tax treaties has increased enormously during the last decades. This trend will continue as more and more treaties are entered into between developing countries and developed countries.

The growing fiscal needs of many states have also increased the danger of tax conflicts and resulting double taxation. Such double taxation must be avoided whether it occurs in its juridical form to a single taxpayer or in its economic form to more than one taxpayer.

The important and growing role of international tax law for a vast number of taxpayers in different countries, both individuals and corporations, has made it more urgent that international tax conflicts be resolved. It is a fact, however, that the present possible methods for resolving these conflicts are insufficient. The deficiencies and possible methods to overcome them are now beginning to be more widely discussed.

The question of resolving disputes in international tax cases has aroused interest, however, since the end of the 19th century. Even the very first double taxation conventions gave rise to the need of resolving cases which were not covered by the conventions. It was realized that the conventions were not sufficient to avoid or reduce double taxation. A procedure to resolve possible problems during the validity of the double taxation conventions was needed.

The period between the two World Wars is of interest since different methods of resolving disputes were used in the double taxation conventions concluded during that time. In some cases the conventions had rules for final decisions made by bodies beyond the control of the contracting States. Soon, however, other rules began to be included in the conventions which authorized the ministries of finance (the competent authorities) to enter into agreements in individual cases in which the intentions of the convention that double taxation should be avoided had not been fulfilled. Such rules began to be the usual ones.

The two methods did not, however, exclude one another. A procedure might start with negotiations between the competent authorities of the contracting States. If no settlement could be reached the procedure could be taken over by an impartial body.

Since the Second World War and particularly with the OECD model treaties the legal situation has become stabilized. Negotiations between the States through their competent authorities – the so-called mutual agreement procedure – has become the accepted method for the resolution of disputes under double taxation conventions.

II. THE MUTUAL AGREEMENT PROCEDURE AND ITS SHORTCOMINGS

The mutual agreement procedure that has to a large extent been standardized by the work of the OECD and its model treaties of 1963 and 1977 may be said to have two basic functions in conventions for the avoidance of double taxation: (1) the improvement, refinement and further development of the convention and (2) a quasi-judicial procedure. It is the second function that is of interest for the resolution of international tax disputes. Its purpose is to arrive at an agreement between the contracting States which eliminates double taxation that is contrary to provisions of the convention as well as double taxation arising from other causes. This purpose is often fulfilled. There are, however, some defects in the present mutual agreement procedure, for which remedies must be found:

1. The most serious defect in the present system is that the mutual agreement procedure does not envisage a method for resolving a deadlock between two contracting States. The causes of such a deadlock can vary. It could be supposed, however, that the most common one is the failure of the competent authorities in the two contracting States to agree on the interpretation of a relevant clause in the convention, so that they are unwilling to conclude an agreement eliminating the double taxation in question.

2. The position of the taxpayer is unsatisfactory. The taxpayer can appeal to the competent authority if he thinks that he has not been taxed according to the convention. The competent authority then decides if it is prepared to initiate the mutual agreement procedure. In some countries, but not in all, unilateral relief can be provided in the event that the mutual agreement procedure is not initiated. The taxpayer has no guarantee that the procedure will be initiated. If it is initiated, he has no guarantee that a decision will be reached.

In the event that a decision has been reached which was unfavorable to him, he might not even have an opportunity to rebut arguments which were adverse to him. He is not formally a party to the procedure which is entirely a matter between two States (or tax administrations). Certainly the taxpayer is often asked to assist his government by producing relevant materials, but he has no guarantee that his views will be heard.

3. Triangular cases are difficult to solve. For example,

1. Commission on Taxation, Document No. 180/240 original nd.

if the shareholders are residents of one country, the corporation is incorporated in a second country and business is done in a third country, the resolution of conflicting tax claims may be difficult. This is primarily due to the bilateral nature of the tax-convention system. The mutual agreement procedure, which reflects the bilateral nature of that system, is not well suited for the satisfactory resolution of complicated triangular cases.

4. Even if two contracting States reach mutual agreement, it is sometimes difficult to implement. Some states have difficulties in implementing such agreements for constitutional reasons, for example if a supreme Court, or even a lower Court, has taken position in a certain case.

III. PROPOSALS

In the opinion of the ICC, the rapid and equitable resolution of international tax disputes is of utmost importance for the promotion of trade and capital investments among the nations of the world. The ICC has thus devoted considerable efforts to the resolution of commercial conflicts. Given the importance of taxation in the world today the ICC thinks it is also very important that conflicts in the tax field should be resolved as rapidly and equitably as possible.

The ICC which has taken up the question of double taxation and the settlement of international tax conflict as early as 1959 therefore welcomes the growing interest in this field and the efforts made by the European Communities, the OECD and the International Fiscal Association. The ICC believes, however, that the approach to this problem has erred on the side of caution. Following years of long discussion, the time is ripe for bold initiatives in order to achieve real progress.

It is of paramount importance for the taxpayer that tax rules be clear and consistently applied. At the international level, he must be able to rely upon the texts of tax treaties. It is intolerable for the specific provisions of tax treaties not to be applied for diverse constitutional, jurisdictional or administrative reasons.

When a State has willingly limited its sovereign powers of taxation by entering into a double taxation treaty with another State, it must be deemed to have assumed full responsibility for the implementation of that treaty in each particular case.

THE MUTUAL AGREEMENT PROCEDURE

The predominance of the mutual agreement procedure as a means of resolving international tax conflicts requires that measures be adopted to ensure a more efficient functioning of this procedure.

1. The taxpayer should have the right to demand the initiation of the mutual agreement procedure.

2. The taxpayer should have the right to submit any materials he wishes to the competent authorities as well as the right to be heard. He should also be authorized to put forward his views to these authorities and to be informed by them about the material aspects of the envisaged decision.

3. The mutual agreement procedure should not be used to review tax matters not directly related to the subject of the procedure.

4. A mutual agreement should be reached within a period of one year from the initiation of the procedure.

5. Once a settlement has been reached, it should be implemented irrespective of time limits in domestic law.

6. A mutual agreement should be implemented in *all* cases, even if taxation incompatible with the treaty has been confirmed by a judicial decision.

7. The taxpayer should have the right to reject any unsatisfactory mutual agreement. The remedies of national tax law should in such cases always be open to him. If the taxpayer and the competent authority so agree, the competent authority may in such a case proceed to arbitration.

8. Most important is that the competent authorities should be obliged to diligently pursue their negotiations, in such a way that double taxation is eliminated in a manner compatible with the treaty.

9. The taxpayer should be protected from paying taxes (in both States) during the mutual agreement or arbitration procedure unless domestic law provides for adequate indemnification.

10. The principles stated here should be used as much as possible even if there is no treaty.

DECISION BY AN INDEPENDENT BODY

If the competent authorities are unable to reach an agreement which they find compatible with the treaty, or if they are unable to resolve the problem within one year, they should at the option of the taxpayer be obliged to submit the case to an independent body.

In the long run, the ICC thinks that it should be possible to set up an *International Tax Court.* Such a Court would have many advantages. It could set precedents and resolve cases where more than two States are involved. The position of the taxpayers would be strengthened.

The ICC recognizes, however, that many legal, practical and psychological obstacles would have to be surmounted before that state is reached. For the present, the pressing problems involved in the resolution of international tax disputes, in the event of an unsuccessful resolution of the dispute under a mutual agreement procedure, should be alleviated by the introduction of *arbitration procedures.*

1. On demand of the taxpayer, the arbitration commission should be formed by each State choosing one member, who in turn choose an impartial chairman. The chairman should be a person who inspires confidence, not only in the competent authorities, but also in the taxpayers.

2. The arbitration commission should reach a solution in conformity with the treaty. Even if its task in a particular case is primarily one of fact-finding (as in a transfer

pricing case), the award should always be based on the treaty.

3. The taxpayer should have the right to present his views to the arbitration commission and put forward his arguments before meetings of the commission.

4. As in the case of the mutual agreement procedure, the award should be implemented in all cases, irrespective of any time limits in domestic law, and even if taxation incompatible with the treaty has occurred as a result of a Court decision.

5. As they have not found a solution to the problems by ordinary means, the costs of the arbitration procedure should be born by the States.

6. If the interests of more than two States having treaties are involved in a particular case (triangular case), the States might choose to form a common arbitration commission for the settlement of the issue. Each State should choose one member who in turn should choose an impartial chairman. If the resulting number of members of the arbitration commission is even an additional impartial member should be chosen. The award should be based on the treaties concerned.

As background to these reflections, the ICC welcomes the fact that concrete measures for introducing arbitration procedures in transfer pricing disputes have been proposed by the institutions of the European Communities. While not wishing to endorse any particular text, the ICC expresses the hope that the European Communities will take prompt action to achieve arbitration of an effective nature, in such form as to provide in conformity with the above mentioned principles, full security against double taxation for all firms subject to taxation by EEC Member States.

The ICC has noted the position of the Committee on Fiscal Affairs of the OECD on arbitration taken in the document "Transfer pricing, corresponding adjustments and the mutual ageement procedure" adopted on 6 July 1982. The ICC regrets that the Committee on Fiscal Affairs in this document has not been able to move forward on this issue.

THE WORLD PEACE THROUGH LAW CENTER

– Its Activities and Publications with Respect to Taxation Matters –

The World Peace Through Law Center is a non-political non-profit institution composed of legal professionals from all over the globe. Formally established as an independent organization in 1963, it is the first world-wide venture to combine the efforts of judges, lawyers, law professors, and others throughout the world into an effective cooperative endeavor to mold a future legal order for humankind that will foster peace by helping to strengthen the world's legal system, both its law rules and its legal institutions and by developing a new international legal machinery to provide for the peaceful settlement of disputes between nations under the rule of law.

The Center's efforts of fostering world peace through law are expressed in all its activities, like its biennial Conferences and its publications.

Several Associations have been created after the Center was founded, including the World Association of Judges, the World Association of Lawyers, the World Association of Law Professors and others.

Within the WAL, close to 100 Committees and Sections have been created, including a *Section on Taxation.*

At the biennial Conferences on the Law of the World, which the Center and its Associations have held since 1963, formal resolutions are formulated by the various panels, and when adopted by the Conference they are sent to the Heads of State of all the nations of the world for their consideration.

At the most recent, 11th Conference held in Cairo, Egypt, in September 1983, the panel on Taxation proposed a *Resolution* concerning "*Taxation of Expatriates*". The text of the Resolution that was adopted by the Conference reads as follows:

> "WHEREAS the Tax Section of World Peace Through Law Center (WPTLC) has examined and considered various national laws with respect to the taxation of citizens and permanent residents of one country but staying or temporarily residing in another country, such persons commonly referred to as "expatriates" for tax purposes; and
>
> WHEREAS the Tax Section of WPTLC believes on the basis of such examination and consideration that while common principles and concepts prevail in the different countries concerning the tax status of expatriates, the national laws and regulations in the various countries are often substantially different, contradictory and uncoordinated,
>
> The Eleventh Conference on the Law of the World, RESOLVES that:
>
> The WPTLC propose to the appropriate organs of the United Nations and the Organization for Economic Cooperation and Development (OECD) to study and explore the feasibility of drafting fair, harmonized and possibly uniform principles and rules for the regulation of the tax status of expatriates, and that if the feasibility of drafting such principles and rules is affirmatively resolved, then such laws be drafted and their adoption by the rule making organs of states be recommended by the OECD and the United Nations, as the case may be."

Also, at the biennial Conferences, work papers are presented, including papers dealing with taxation matters. The titles and authors of some of the work papers that have been presented in the last several years on the subject of taxation are as follows:

Gustaf Lindencrona and Nils Mattsson (Sweden): "Summary of the Study of the Feasibility of World Tax Court"; Nathan Boidman (Canada): "International Tax Avoidance: The Impact on Legal Systems"; G.S. Anderssen (Australia): "Australian International Tax Agreements"; Nicholas R. Doman (U.S.A.): "Adjusting Taxation for Inflation in the United

States"; D.C. Singhania (India): "Inflation and Taxation Law in India"; K.D. Gaur (India): "Standard of Proof under the Income Tax Laws of India".

The next, 12th biennial Conference on the Law of the World will be held in Berlin (West), 21-26 July 1985, again in cooperation with the WAL and the other Associations affiliated with the Center. The Conference promises to be a tremendous success. The President of the Federal Republic of Germany is expected to preside over the Conference as the Honorary President and to deliver the inaugural address. A demonstration trial on a subject of current international interest will be held as well as panel discussions and speeches about a number of critical international legal problems, including on the subject of taxation. The title of the tax panel will be "Taxation: National cooperation encourages international trade".

For inquiries about any of the matters above please write to Mrs. Margaretha M. Henneberry, World Peace Through Law Center, 1000 Connecticut Avenue, N.W., Suite 800, Washington, D.C. 20036, U.S.A.

EUROPEAN COMMUNITIES:

Commission proposes improved tariff preferences for developing countries in 1985[1]

The Commission has just finalised its proposals to the Council of Ministers for the 1985 Generalised Scheme of Preferences (GSP). These proposals, which fall within the framework established by the Council for the period 1980-85, improve the 1984 arrangements by increasing the value of preferential import possibilities of both industrial and agricultural products by an average of 4.7%.

The Community's 1985 Scheme will cover some 18,000 million ECU of developing countries' exports and will offer them potential savings in customs duties of 800 million ECU. (To put this figure in perspective it can be compared with the Community's budget for financial and technical assistance to developing countries which totalled 800 MECU in 1983 and which is only one of the Community's development instruments). This preferential access for developing countries is additional to that granted in the framework of the Convention of Lome to 64 ACP countries and of the cooperation agreements concluded between the Community and most Mediterranean countries.

The proposal confirms the Community's position as the major GSP donor among the industrialised countries. The Community's GSP is open to all Third World countries. It gives duty free access for all industrial products. In the agricultural sector the Community offers reduced import duties on some 390 products such as canned pineapples and other tropical fruit and fruit juices, crustaceans, soluble coffee, unmanufactured tobacco and palm and coconut oil.

The least developed countries will, in the Community scheme, continue as in the past to have unlimited duty free access for all industrial products as well as for almost all agricultural products which are not subject to an import levy.

No other major scheme offers such wide product coverage, including such sectors recognised as sensitive as textiles, footwear and steel products, all of which are excluded either wholly or in part by other donors. As far as country coverage is concerned, the Community accepts the Group of 77 as agreed by the developing world itself while certain industrialised countries exclude OPEC countries, state trading countries and even some of the world's least developed countries from the benefit of their schemes.

The Community sees preferential access to its market as an important element in its development strategy towards economic expansion in the Third World. Moreover, trade is an essential factor for relieving the indebtedness which has reached staggering proportions in certain developing countries. Indeed some of the major debtors within the Third World, such as Brazil, Romania, Venezuela and India, are also major beneficiaries of the Community's GSP. Their trade under the Community's GSP in 1982 was respectively 958, 863, 645 and 620 million ECU.

THE PROPOSALS FOR 1985

The Commission is proposing that wherever possible the preferential quantitative limits imposed on some 130 sensitive products out of a total of 1800 industrial products should be increased by between 5% and 15%. For certain sectors where the European industry is in considerable difficulty, namely leather, shoes, glass, ceramics and iron and steel, a status quo has been proposed.

In keeping with its policy of simplifying the operation of the GSP the Commission has removed 12 **industrial products** from the list of sensitive industrial products for which preferential access is subject to quantitative limitations. It has liberalised the arrangements for a further 11 products. For these there will no longer be individual quotas but only indicative ceilings which are much less stringent.

In the **agricultural sector** the Commission has proposed that preferential access for 71 products should be widened and that four new products should be included namely inulin, chicory roots, locust beans and cheese fondues. The Commission has also proposed reductions in duty within the quota for tobacco and a redistribution of all the quotas for processed agricultural products to take account of real trade flows between the individual Member states and the beneficiary countries.

For **textiles** the Commission has suggested a modest increase in the general level of import ceilings taking into account the sensitivity of this sector.

As a final measure the Commission has also proposed more flexibility in the management of the quotas to take more account of real trade flows.

The Council of Ministers should take a formal decision on these proposals in November 1984 after consulting the European Parliament and the Economic and Social Committee.

1. COM (83) 378.

EUROPEAN COMMUNITIES

Action Against Unitary Taxation

On 2 February 1984 Mr. Pierre-Bernard Cousté, member of the European Parliament, submitted the following question to the EC Commission:[1]

> Can the Commission say whether it has called on the United States to abolish the "unitary tax" introduced by a number of States and which results in the dual taxation of international companies with their head offices in Europe?
>
> What success has the Commission achieved?
>
> Which States have now adopted this system and which companies have been affected? Is it possible to make an assessment of the financial impact of this form of taxation and its implications for each of the Member States?

On 27 March 1984 Commissioner Haferkamp replied on behalf of the Commission:

> The Commission has coordinated action by the Member States in making representations to the United States Government. Since March 1980 five diplomatic notes have been delivered to the Department of State, Washington, requesting action in this matter, which would put an end to this practice at State level. The most recent representations were made on 1 August and 23 September 1983.
>
> The Commission has joined with Member States in making a submission expressing the concern of the Community to the Working Group recently established by President Reagan to explore and seek to resolve the complex issues involved in States' use of the world-wide Unitary method of taxation.
>
> The Commission also cooperated with Member States when the latter intervened as amici curiae in the case Shell Petroleum NV v. Franchise Tax Board before the Supreme Court. The question of unitary taxation was raised by the Commission with U.S. ministers in the course of the High Level meeting held in Brussels on 9 December 1983.
>
> To date no action to remove the grievances of European multinational firms has been taken in the U.S. The working group established by the President hopes to produce agreed recommendations very soon.
>
> According to the latest information held by the Commission, the following 12 States apply some form of unitary taxation with world-wide combined reporting: California, Oregon, Alaska, Colorado, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Utah and Florida.
>
> Information on individual Community companies affected by the operation of world-wide unitary taxation is not held by the Commission and the total amount of tax involved for the Community as a whole or for individual Member States is not known.

1. Official Journal of the European Communities C 141 of 28 March 1984.

OECD:

Tax Expenditures: A review of the Issues and Country Practices

"Tax Expenditures: A Review of the Issues and Country Practices". 88 pages, OECD, Paris, 1984. ISBN 92 64 12588 2. Available from OECD Sales Agents.

Tax reliefs can be used to achieve the economic and social policy goals of governments in an analogous way to direct spending programmes. They are found over the whole range of taxes, but are particularly prevalent in the personal and corporate income tax systems. Where tax reliefs are clearly being used to implement a government programme, they are increasingly being referred to as tax expenditures, to emphasize their similarities to direct spending programmes.

Tax expenditures have become increasingly important at a time when control of the growth of the public sector has become a major preoccupation of most OECD Member Countries. This has led the OECD's Committee on Fiscal Affairs to examine a number of issues raised by these subsidies both for policymakers and technicians, and the results have recently been published by the OECD. The report examines, inter alia, the impact of tax expenditures on the "size" and "transparency" of government programmes; the choice between direct and tax expenditures; the techniques for measuring tax expenditures.

What are tax expenditures?

They are considered as departures from the "generally accepted" or "normal" tax structures which produce a favourable tax treatment of particular types of activities or groups of taxpayers by reducing their tax liability. Thus, for example, householders or companies may be offered advantageous tax arrangements, or even complete tax exemption, to encourage savings or new investments.

Tax expenditures or direct expenditures?

Many government programmes (e.g. subsidising investment) can be implemented either by providing tax expenditures or cash transfers to the eligible beneficiaries. The choice between these alternative "delivery" systems should ideally depend upon which will achieve the aims of the programme in the most efficient and equitable way, and the report therefore does not take up a position as to whether tax or direct expenditures are to be preferred. The choice would depend upon the programme aims, the type of tax expenditures to be used, the institutional framework. However, the report identifies a number of differences in using the tax system or direct expenditures. For example, tax expenditures are usually less transparent than direct expenditures which can lead to difficulties in evaluating a programme and in controlling its cost; the value of a tax subsidy will usually increase with the marginal rate of tax, and therefore higher income taxpayers will receive a larger subsidy than lower income taxpayers.

Among the arguments in favour of tax expenditures are, as far as social transfers are concerned, that they avoid the social stigma sometimes attached to direct payments, which may be seen as "social handouts", and their greater flexibility which allows the individual or firm to decide how much of the subsidy to use. A disadvantage is that their proliferation may increase the complexity of tax systems and jeopardize the overriding aim of tax systems to raise revenue in an efficient and equitable way.

Three approaches to the control of tax expenditures

Whilst all governments agree that information on the cost of subsidies given through the tax system is a prerequisite for rational policymaking, there remains widespread disagreement upon how this information should be provided.

In the majority of OECD countries, information on tax reliefs is provided on an "ad hoc basis" when specific policy issues are being reviewed. But seven countries (Australia, Austria, Canada, France, Germany, Spain, United States) provide regular tax expenditure consolidated accounts, which are generally attached to the annual budgetary statements.

A third approach, between the ad hoc and consolidated account solutions is followed by Ireland, Portugal and the United Kingdom, which provide periodic listing of the most important tax reliefs, but without attempting to separate those tax reliefs which would be considered as tax expenditures from those which form part of the "normal" of "benchmark" tax structure.

Finally, the report discusses some of the technical problems associated with evaluating the cost of tax expenditures.

IFA news

Some Highlights from the Secretary General's 1983-84 Annual Report Presented at the Buenos Aires Congress 1984

IN GENERAL

The Secretary General points out that IFA should not become an elitist group although it should remain selective as to the admission of members. However, it is vital that academics and younger persons also be able to join IFA and it is for this reason that he welcomes the fact that membership fees are relatively low and can be considered "good value for money". A further reduction of these fees is being contemplated (see below).

However, Congress fees have reached a level that it is now open to debate whether IFA Congresses are still accessible to all income groups, and the Invitations Sub-Committee urges the National branches to make congresses not too costly. A survey of congresses organized by comparable organizations will be made to see whether IFA is not overreaching itself.

VENICE CONGRESS

The 37th IFA Congress took place at the Cini Foundation on the Isola di San Giorgio in Venice. It would be difficult to imagine a more interesting and beautiful place to hold a congress and IFA is in particular indebted to the Hon. Prof. B. Visentini, President of the Italian Branch, Prof. Avv. P. Adonnino, Chairman of the Congress organising Committee and member of IFA's Executive Committee, and Prof. Avv. A. Fantozzi, Secretary of the Congress and Member of IFA's Permanent Scientific Committee.

With respect to Subject I – "*Tax avoidance/Tax evasion*" – Prof. A. Fantozzi (Italy) was the Chairman of the Working Session, Prof. J. van Hoorn Jr. (Netherlands) Discussion Leader, Prof. V. Uckmar (Italy) General Reporter, and Messrs. J.B. Bracewell-Milnes (U.K.), J. Guttentag (U.S.A.), P. Olavarietta (Mexico) and S. Rolt (Singapore) were the Panelists.

With respect to Subject II – "*International problems in the field of general taxes on sales of goods and services*" – Prof. P. Adonnino (Italy) acted as Chairman, Prof. P. Sibille (Belgium) as Discussion Leader, Prof. DDr. H.G. Ruppe (Austria) as General Reporter, and Messrs. M. Alderighi (Italy), H. Gonzales Cano (Argentina), H. Mattausch (Fed. Rep. of Germany), P. Guieu (Belgium) and Mrs. A. Scheider (Israel) as Panelists.

The Seminar on "*Tax policy towards the national heritage*" was chaired by Prof. I. Claeys Boúúaert (Belgium). Messrs. B. Visentini (Italy), G. de Ulhôa Canto (Brazil), R.K. Kleeberg (Fed. Rep. of Germany), M. Lainé (France) and O.D. Stanley (U.K.) were the Panelists.

NEW IFA OFFICERS

Mr. S. Ambalavaner (Sri Lanka) joined the Permanent Scientific Committee as its new member. Similarly, one new member joined the Executive Committee: Mr. J. Sainz Alarcon (Mexico). Also invited to attend the meeting of the Executive Committee were Dr. A.R. Lopéz and Dr. V. O'Diaz from Argentina in view of the 1984 Buenos Aires Congress.

NATIONAL BRANCHES

At the Venice Congress, a new Branch from the Republic of Korea was recognized, which brings the total of IFA Branches to 34. Persons playing a leading role in the Korean Branch are Prof. Tai Ro Lee and Mr. Woo Taik Kim. IFA now has approximately 6,500 members.

Some Branches have been very active throughout the year by holding meetings,tax workshops, seminars and meetings with other branches. News received with respect to these meetings was passed on for publication in the *Bulletin for international fiscal documentation*.

MEMBERSHIP FEES

For the year 1984 the contribution was:

- US$ 38 for individual members of National IFA Branches;
- US$ 40 for direct individual members of IFA;
- US$ 90 for corporate members, both direct and of National Branches.

The Executive Committee proposes to reduce the membership fees for 1985 to:

- US$ 28 for individual members of National IFA Branches;
- US$ 30 for direct individual members of IFA;
- US$ 70 for corporate members, both direct and of National Branches.

MITCHELL B. CARROLL PRIZE 1983

Dr. M. Görl (Fed. Rep. of Germany) won the Mitchell B. Carroll Prize 1983 for his work: *Die freien Berufe im Internationalen Steuerrecht der Bundesrepublik Deutschland (Independent Professions under International Tax Law of the Federal Republic of Germany)*.

BUENOS AIRES CONGRESS 1984

At the time of writing the 1983-84 Report, preparations for the Buenos Aires Congress were nearing completion. The venue will be the Sheraton Hotel in Buenos Aires.

Prof. Dr. Klaus Vogel (Fed. Rep. of Germany) will be the General Reporter for Subject I – *Fiscal obstacles to the international flow of capital between a parent and its subsidiary*; Prof. Dr. J.A. Macón and Prof. Dr. E.J. Reig (Argentina) will be the General Reporters for Subject II – *Social security contributions as a fiscal burden on enterprises engaged in international activities.*

Discussion leaders will be Prof. Avv. A. Fantozzi (Italy) and Mr. G.L. Herring (Australia). Chairmen of the Resolutions Committee are Mr. G. Coulombe (Canada) and Prof. A. Nooteboom (Netherlands).

Dr. A. Schindel (Argentina) will be the Chairman of Seminar A (*Adjustments for tax purposes in highly inflationary economies*). Panelists will be Mr. Ives Gandra da Silva Martins (Brazil), Mrs. Casanegra de Jantscher (Chile and also the IMF), Prof. A. Yoran (Israel), Mr. W. Rossi Bayardo (Uruguay) and Mr. Balzarotti (Argentina).

Two other Seminars will be held, i.e. Seminar B (*Legal and fiscal aspects of foreign investment in Argentina*) and Seminar C (*Tax structure and distribution of taxing powers in Argentina's federal system*).

FUTURE CONGRESSES

1. London Congress 1985

The subjects for the London Congress 1985 were selected:

Subject I: *The assessment and collection of tax from non-residents* (General Reporters: Messrs. M. Collins and J.S. Phillips (U.K.)).

Subject II: *International double taxation of inheritances and gifts* (General Reporter: Mr. W. Goodman (Canada)).

2. New York Congress 1986

The subjects decided upon were:

Subject I: *Taxation of assets transferred into and out of the taxing jurisdiction* (General Reporter: Y. Kergall (France)).

Subject II: *Currency fluctuations and international double taxation* (General Reporters: Mrs. M. Burge and Mr. P. Farber (U.S.A.)).

In memoriam

Professor Stanley S. Surrey

IFA announces with sorrow the death of Professor Stanley S. Surrey on 27 August 1984, at the age of 74 years.

Professor Surrey was Assistant Secretary for Taxation Policy of the U.S. Department of the Treasury from 1961 to 1969. During that period he developed an approach to the Tax Expenditure Budget, which led, in 1973, to the publication of *Pathways to Tax Reform – the Concept of Tax Expenditures,* an original and pioneering work on tax expenditures.

Before 1961 and after 1969, Professor Surrey taught tax law at Harvard University. In addition to numerous publications he was involved in the International Tax Program of Harvard Law School and took an active and important part in the work of the U.S. Group of Experts on Tax Treaties between Developed and Developing Countries.

At the time of his death, Professor Surrey was Jeremiah Smith Emeritus Professor of Law at Harvard University, visiting professor at Boston College Law School, and Member of the Permanent Scientific Committee of IFA.

The international tax world has lost one of its most outstanding scholars and the IFA a long-time friend.

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1984 issue. See also Erratum (p. 193 of the May 1984 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Africa

EXPLORING COUNTERTRADE
opportunities in Africa.
Geneva, Business International S.A., 1984. 166 pp.
This survey explores the economic outlook in Africa and the implications for countertrade. The evolution of contertrade is examined and basic techniques and strategies for Africa are described. After a brief survey of African Government policies on countertrade, a number of case studies is reported.
(B. 13.218)

FISCAL INCENTIVES – TAX
policy as an instrument of economic development, in cooperation with the Economic Commission for Africa (ECA) – Report.
Seminar convened by the German Foundation for International Development from 12-23 July, 1982 in Berlin.
Berlin, German Foundation for International Development [Rauchstrasse 22, 1000 Berlin 30], 1982. 273 pp.
Full texts of the working group reports and seminar papers and country reports, including: Fiscal incentives in Uganda, by George E.L. Okutu; Fiscal incentives for investment in Ethiopia, by Gebeyehu Alemneh.
(B. 56.447)

Mozambique

DIREITO FISCAL MOÇAMBICANO.
(Algumas considerações).
Maputo, Embaixada de Portugal, 1983. 30 pp. (photocopies).
Some considerations on taxation in Mozambique, prepared by the Portuguese Embassy in Maputo (Mozambique).
(B. 13.215)

Nigeria

AKINOLA AGUDA, T.
The judiciary and the 1983 elections.
Lagos, The Nigerian Institute of Advanced Legal Studies [P.M.B. 12820], 1983. 19 pp.
(B. 13.194)

OLUYEDE, P.A.
Public complaints commission in a presidential system with particular reference to Nigeria.
Lagos, The Nigerian Institute of Advanced Legal Studies [address see above], 1983. 19 pp.
(B. 13.195)

AKANDE, Jadesola O.
The constitutional relevance of the provision for the seat of Government.
Lagos, The Nigerian Institute of Advanced Legal Studies [address see above], 1983. 15 pp.
(B. 13.196)

AL FARUQI, Ismail R.
Humanism and the law: the case of the Shari'ah.
Lagos, The Nigerian Institute of Advanced Legal Studies [address see above], 1983. 17 pp.
(B. 13.197)

ADI, Isabella E.
Judicial attitudes to freedom of speech and the press with particular reference to contempt of court.
Lagos, The Nigerian Institute of Advanced Legal Studies [address see above], 1983. 23 pp.
(B. 13.193)

Zimbabwe

ZIMBABWE EXPORT DIRECTORY 1984.
Harare, Confederation of Zimbabwe Industries [Industry House, 109 Rotten Row], 1984. 87 pp.
(B. 13.219)

ASIA AND THE PACIFIC

ASEAN

SKULLY, Michael T.
Merchant banking in ASEAN. A regional examination of its development and operations.
Selangor, Oxford University Press [3, Jalan 13/3, Petaling Jaya, Selangor, Malaysia], 1983. 200 pp., S $ 27.50.
The material presented in this research report was collected in each of the ASEAN member countries during 1979 and 1980.
(B. 56.445)

Asia

TRAINING IN TAX
auditing and investigation. Advanced training course for senior tax officers from Asian countries.
14 August to 27 October 1983 in Berlin (West), Bonn and Hersching (Bavaria).
Report.
Berlin, German Foundation for International Development [address see above], 1983. 341 pp.
Full texts of working papers and country reports on Burma, Malaysia, Pakistan, Philippines, Singapore and Sri Lanka.
(B. 56.446)

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World Peace Through Law Center, 1000 Connecticut Avenue. N.W., Suite 800, Washington D.C. 20036, U.S.A.

CUMULATIVE INDEX 1984 – Nos. 1 - 9

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Corporation Taxes in OECD Member Countries

By Sijbren Cnossen

Sijbren Cnossen is Professor of Taxation and Dean of the Economics Faculty of Erasmus University Rotterdam. This article is based on a paper presented at the Intensive Workshop on Issues in the Taxation of Capital Gains at Ballarat, Australia, 26-27 February 1984. The author is grateful to Carl S. Shoup and Roger S. Smith for their comments on an earlier draft.

INTRODUCTION

Corporation taxes are important, because corporations are social and economic institutions of great impact. As separate legal entities, corporations have the power to contract, the right to hold and convey title to property, the capacity to sue and to be sued, and the authority to make rules and bylaws. Corporations have a life independent of the lives of any or all of their shareholders, they may multiply like the sand of the sea, and in principle corporations are legally "immortal". The power of a large transnational corporation approximates that of the government of a medium-sized country. Although no doubt there are exceptions that prove the rule, the total impact of a corporation is truly more than the sum of the influence of the individual parts.

The social and economic importance of the finding of the corporate form of business organization has rightly been compared to the discovery of steam and electricity.[1] Corporations have reshaped the world in which we live. In most countries, a large part of national product is generated in the corporate sector and its activities exercise a profound influence on the remainder of the economy. Modern industrial development is absolutely unthinkable without the corporate business form in which capital and labor are combined for productive, mutually beneficial, purposes. Without exaggeration, the corporation may be characterized as "the central economic institution of modern society".[2]

This paper surveys and evaluates the various forms of tax that are imposed on corporate profits. As a tax on income, the corporation tax interacts with the individual income tax of shareholders entitled to corporate profits. In tax law and theory, such interaction may be denied or explicitly recognized and reflected in the form of the tax. The first section, therefore, delineates the various forms of corporation tax and reviews their role in countries that are members of the Organisation for Economic Co-operation and Development (OECD). The second section discusses the two poles of the corporation tax philosophy: the classical system that views the corporation as an entity distinct from its shareholders, and the conduit system that regards it as an extension of those shareholders. In practice the corporation tax and the income tax are integrated only with respect to the taxation of distributed profits. The third section examines the schemes for such integration at corporate level and at shareholder level. Finally, the fourth section summarizes and evaluates the various systems. I conclude that the imputation system appears the preferred form of corporation tax for domestic considerations, but that its international implications deserve careful study.

1. For the reference see Goode (1951, p. 11).
2. Mason (1968, p. 396) in *International Encyclopedia of the Social Sciences.*

Contents

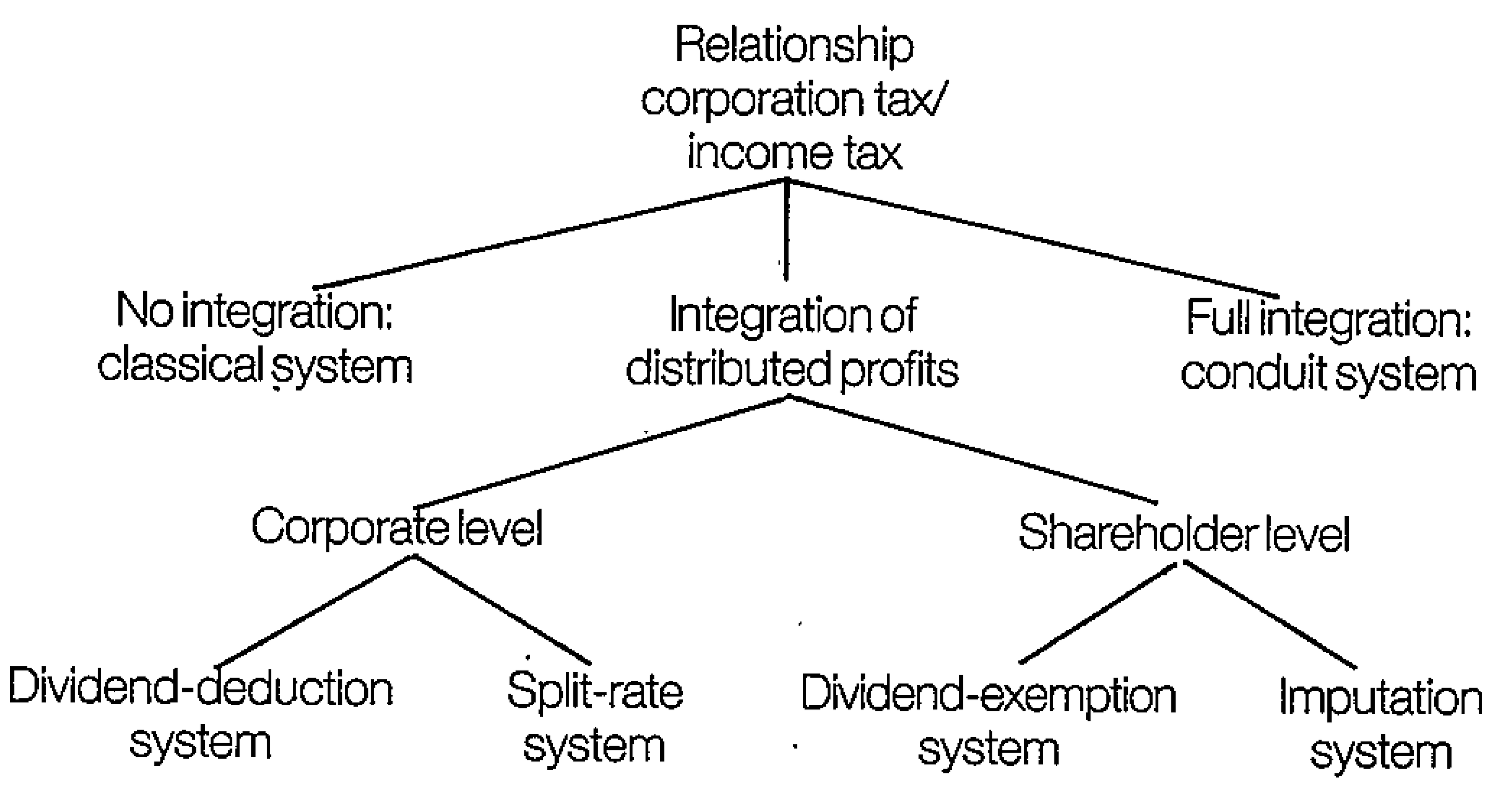
I. ROLE OF CORPORATION TAX

The role of the corporation tax in various countries, particularly as regards its relationship to the income tax, is reflected in the forms of the tax. Forms differ as shown by a survey of corporation taxes in OECD member countries. Their revenue importance is also noted.

A. Forms of corporation tax

Figure 1 presents the various forms of corporation tax that can be distinguished depending on whether and to what extent they are integrated with the income tax of shareholders. At one extreme, the corporation is regarded as an entity entirely separate from its shareholders and taxed as such (classical system).[3] At the other extreme, the corporation is viewed as a pass-through, a conduit, of all corporate source income of shareholders, distributed as well as undistributed earnings. The corporation tax, if retained, serves solely as a prepayment for the income tax, just like a wage withholding scheme.

Figure 1



In practice, the integration of the corporation tax with the income tax of shareholders is limited to distributed profits (dividends). This form of partial integration, often referred to as dividend relief, can be achieved at corporate level or at shareholder level. The most obvious method of integration at corporate level is to permit a deduction for dividends from taxable profits, as is commonly done for interest. This is called the dividend-deduction system. Another approach that essentially achieves the same result is the split-rate system under which a lower rate of tax is levied on distributed profits. At shareholder level integration may be provided simply by exempting dividends from income tax. More importantly, integration may also be achieved under an imputation system that permits shareholders a full or partial credit for the corporation tax that can be imputed to the dividends received by them. In essence, the imputation system works as a dividend withholding tax.

The appendix to this paper shows that the degree of integration or dividend relief can be made the same under the dividend-deduction system, the split-rate system, and the imputation system (but not the dividend-exemption method). For this equivalency to hold, it must be assumed that the choice of the integration system does not affect the payout rate.

B. Survey and revenue importance

Table 1 shows the various corporation tax systems in OECD member countries, their rates and contribution to revenue. Out of 23 countries, 7 countries levy the corporation tax in its classical garb. Sixteen countries permit some form of dividend relief either at the corporate level by way of a dividend-deduction (4 countries) or a split-rate (3 countries) system, or at shareholder level through an imputation system (9 countries). No country has the dividend-exemption method, although Greece permits it on an optional basis. Mixed imputation/split-rate systems are found in Germany and Japan. The equivalence between some systems is apparent from the Norwegian and Portuguese examples. Whereas Norway allows a deduction of dividends for national but not for local corporation tax purposes, Portugal achieves the same objective by exempting distributed profits from the corporation surtax. In these cases, the system's dominant characteristic or its legal form has been taken as the main classification criterion.

Most corporation tax rates lie in the 40-50% range. The unweighted average for all OECD member countries is 47.4%. In addition to the national corporation tax, several countries, mainly those with federal forms of government, have local corporation taxes which, if differentially applied, are generally condemned in the professional literature because of their negative allocative effects.[4] The rationale is also weak for levying lower rates of tax, as many countries do, on small amounts of profits which are not necessarily characteristic of small companies. Such rates do impart a slight degree of progressivity to the corporation tax but, except by coincidence, this should not reflect the tax burden distribution at shareholder level. It should be noted that effective rates of tax, i.e. actual tax payments expressed as a percentage of economic income, may vary widely (not necessarily in the same direction as statutory rates) on account of differences in the way in which taxable profits are determined.

As indicated in Table 1, on average the corporation tax contributed 7.8% of total tax revenue, or 2.8% of gross domestic product (GDP) in 1982. For comparative purposes, it should be noted that yields of imputation systems include the (creditable) "income tax" portion, whereas integration systems at corporate level, of course, leave the income tax out of account. In the period 1965-1982 the share of the corporation tax in total tax revenue declined, but the ratio to GDP increased, implying that corporation tax receipts rose less than those of other taxes. This observation modifies the generally held position that corporation taxes are a declining source of revenue due to erosion of the tax base (tax in-

3. The label "classical system" was introduced by Van den Tempel (1970, p. 7). It should be noted, however, that, contrary to what the terminology suggests, the imputation system, discussed below, is of older date. In the 19th century, some German states already had some form of imputation and in 1922 it was incorporated as the withholding method in the Model Income Tax Ordinance of the United Kingdom which was introduced in many colonies. Lent (1977) reports that out of 78 developing countries, 32 counries provide dividend relief. Of this number, 14 have an imputation system, 6 tax retained profits only, and 12 exempt dividends from income tax.
4. See McLure (1983).

Table 1
Corporation taxes in OECD Member Countries, 1983

Type of tax and country	*Total standard rate* [a) b) c)]	*Revenue contribution* — *As percent of total tax revenue* 1965	1982	*As percent of GDP* 1965	1982
I. *Classical System*					
Australia	46	16.1	10.0	3.9	3.1
Luxembourg	47.3	11.1	15.4	3.4	5.8
Netherlands	43	8.0	6.8	2.9	3.1
New Zealand	45	20.7	7.9	5.1	2.7
Spain	35	9.2	4.7	1.4	1.2
Switzerland	14.2–19.3[d)]	7.1	6.2	1.5	1.9
United States	50.3[e)]	15.8	7.0	4.2	2.1
II. *Integration Systems*					
A. Corporate Level					
1. Dividend-deduction					
Finland	59	8.2	4.5	2.5	1.7
Greece	48.5	1.9	4.0	0.4	1.3
Norway	50.8	3.8	16.5	1.3	7.9
Sweden	57.4	6.1	3.3	2.2	1.7
2. Split-rate					
Austria	60.9/36.9	5.4	2.9	1.9	1.2
Japan	56.4/44.4	17.8	19.7	3.2	5.4
Portugal	52/40	—	—	—	—
B. Shareholder Level					
1. Dividend-exemption[f)]					
2. Imputation					
Belgium	45	6.2	6.1	1.9	2.8
Canada	47–52	15.1	8.0	3.9	2.8
Denmark	40	4.5	2.6	1.4	1.1
France	50	5.3	5.1	1.8	2.2
Germany	63.3/46.7	7.8	5.1	2.5	1.9
Ireland	50	9.1	4.7	2.4	1.9
Italy	40.5	6.9	8.0	1.9	3.2
Turkey	40	4.8	12.7	0.7	2.6
United Kingdom	52	7.0	9.6	2.2	3.8
III. *Unweighted Average*	47.4	9.0	7.8	2.4	2.8

Footnotes

a) In computing the total standard rate –
   1) local corporation tax rates (on an average basis if differentiated) are included in Austria, Canada, Finland, Germany, Italy, Japan, Luxembourg, Norway, Sweden, Switzerland, and the United States;
   2) surcharges or surtaxes are included in Italy, Luxembourg, and Portugal (but not in Canada);
   3) the statutory tax-exclusive local tax rates in Austria, Germany and Luxembourg have been converted to tax-inclusive rates as follows: $t_i = t_e/(1 + t_e)$ in which t_i is the tax-inclusive rate and t_e the tax-exclusive rate;
   4) local taxes on corporate profits are deductible in computing taxable profits for the national corporation tax in Austria, Germany, Italy, Japan (corporate enterprise tax), Luxembourg, Sweden, and the United States; the effective total corporation tax rate then equals $t_s(100 - t_i) + t_i$ in which t_s is the statutory national tax rate and t_i the (effective) tax-inclusive local tax rate.

b) Some countries levy lower (New Zealand) or higher (Netherlands, Norway, Spain) corporation tax rates on specified mining (petroleum) companies, higher rates on non-resident companies (Australia, Belgium, New Zealand), or lower rates on manufacturing and processing operations (Canada, Ireland).

c) Lower corporation tax rates on small profits or, sometimes, small corporations are levied in Austria, Belgium, Canada, Finland, Ireland, Japan, Luxembourg, Portugal, Switzerland, the United Kingdom, and the United States.

d) Rates vary in proportion to the ratio between taxable profits and equity capital. Because of its unusual character, the Swiss corporation tax rate has been left out of consideration in computing the average tax rate for OECD member countries.

e) In addition to the regular corporation tax, a tax of 15%, called an add-on minimum tax, is imposed on preference items.

f) At the shareholder's option dividend income is exempt in Greece. Furthermore, Canada, the Netherlands, and the United States exempt a small amount of dividend income.

Sources
Alexander Berger, ed., *International Tax Summaries 1984*, published for Coopers & Lybrand International Tax Network by John Wiley (New York, 1984); International Bureau of Fiscal Documentation, *The Taxation of Companies in Europe* (Amsterdam, looseleaf); and Organisation for Economic Co-operation and Development, *Revenue Statistics of OECD Member Countries 1965-1982* (Paris, 1983). It should be noted that the information on corporation tax rates may not be up-to-date or complete. Iceland is not included.

centives), increased capital-intensity of manufacturing (higher initial write-offs), and a shift in economies to service industries (larger wage bills).[5] Although in most countries the corporation tax is not a negligible source of revenue, surely its yield is disproportionately smaller than the attention, also in this paper, devoted to its form and structure. One reason may be the high visibility of the tax.[6] Whatever the case, even corporations that pay little or no tax are still subjected to all its complexities, attendant compliance costs and excess burdens.

II. CLASSICAL SYSTEM VERSUS FULL INTEGRATION

The essence of the corporation tax debate can best be illustrated by contrasting the classical system with the conduit or full integration system. The case for full integration can be made on ability-to-pay grounds, but this paper emphasizes the distortions that emanate from the classical system.

A. Classical system

Seven OECD member countries have the separate entity system of corporation tax. In computing taxable profits, no deduction is allowed for profit distributions (dividends) to shareholders. Moreover, those distributions are taxed again in their hands at rates that differ from one shareholder to another – depending on the amount of dividend and their other income – but that may range from the lowest to the highest marginal rate of the progressive income tax. The Netherlands and the United

5. See Bird (1980, p. 5-6) who refers to Conrad (1974).
6. Managers of large corporations generally have to sign the tax return themselves, something they usually do not do with respect to sales tax returns, for instance, that often involve much greater tax liabilities.

States exempt a small amount of dividend income at shareholder level, but this does not really affect the classical nature of the system.

The workings of the classical system are illustrated in Example 1. It is assumed that the profits of a corporation before dividend distributions and corporation tax are $ 300 which are taxed at a rate of 50%. Remaining profits of $ 150 are distributed in full and taxed again at shareholder level at individual income tax rates of, say, 30% or 70%, resulting in income tax liabilities of $ 45 and $ 105, respectively. Combined corporation and income tax payments are $ 195 or $ 255. When expressed as a percentage of original corporate source income, these payments translate into effective tax rates of 65% for the 30% bracket and 85% for the shareholder whose dividend falls in the 70% bracket. If these effective rates in turn are compared to the appropriate marginal tax rate of each shareholder, the dividend income of the 30% shareholder is "overtaxed" by 117% and that of the 70% shareholder by 21%.

Example 1
Classical system

A.	*Corporate level*		($)
	1. Profits before corporation tax		300
	2. Corporation tax: 50% (1 × 2)		150
B.	*Shareholder level*		
	3. Income tax rate	30%	70%
	4. Dividend income (1 − 2)	150	150
	5. Income tax (3 × 4)	45	105
C.	*Combined tax burden*		
	6. Total tax (2 + 5)	195	255
	7. Effective tax rate (6 ÷ 1)	65%	85%
	8. Overtaxation [(7 − 3) ÷ 3]	117%	21%

In the tax literature, the effect of the interaction between the corporation tax and the income tax is referred to as the double taxation of distributed profits. This description is pejorative in the sense that corporate source income, if retained, may also be undertaxed.[7] Essentially, in the conduit view, the issue is not that dividend income is taxed twice, but that corporate source income, distributed as well as retained profits, is not taxed in accordance with the marginal income rates of shareholders. Of course, proponents of the classical system deny the relevancy of the interaction between the two taxes. They point out that ownership and control functions have been completely divorced from each other in the large public corporation and that shareholders, except in rare instances, have no legal claim on earnings until dividends are declared by management.[8] In their view, shareholders are little more than subordinate creditors.

B. Economic distortions

Whatever the argument that the separate personality of a corporation justifies a separate tax, the systematic overtaxation of distributed profits under the classical system brings a number of undesirable economic effects in its train which deserve to be taken seriously.[9]

Firstly, the double taxation of dividend income should induce corporations to retain rather than distribute their earnings. This is so because shareholders can earn a higher net of tax return on reinvested retained profits than on distributed profits that are newly invested. Thus, retained earnings are not subjected to what is called "the test of the market place"; hence, they may be applied for socially less productive purposes.[10] Furthermore, firms with excess retained profits may use them to strengthen their market position through mergers. This may reinforce monopolistic tendencies in the business world and worsen the starting position of new firms.

Secondly, the classical system encourages firms to attract relatively more debt than equity. New equity is more expensive than new debt, because dividends, unlike interest, are not deductible in ascertaining taxable profits.[11] The preference for debt, stronger under inflationary conditions, increases the influence of the risk-averse creditor, as well as the cost of capital on account of the higher risk premiums that must be paid. The deterioration of the capital structure of highly levered firms jeopardizes their solvency (and that of other firms). Firms become more vulnerable to a downturn in the business cycle that is accompanied by a fall in the return on total capital below the interest that must be paid to holders of debt.

Thirdly, the classical system may distort the most efficient allocation of capital between firms for which the corporate form is a conditio sine qua non for doing business and other firms. The higher tax on gross income in the corporate sector means that the net return on capital employed by corporations will be lower than the comparable return in the noncorporate sector, inducing a capital flow from the former to the latter sector until the net returns in both sectors are again equal. But this implies that production in the corporate sector is below the level that corresponds to an optimal allocation of resources.[12]

Fourthly, welfare losses arise because proprietorships have a tax-induced preference for the corporate form of doing business in order to avoid marginal rates of income tax that exceed the corporation tax rate. This involves an artificial flow of capital into the corporate sector which adds to rather than offsets the efficiency losses of corpo-

7. If in Example 1 all profits would have been retained in the corporation, the effective tax rate for both shareholders would have been 50%. In other words, the 30% shareholder would still be overtaxed, namely 67%, but the 70% shareholder would be undertaxed by 29%. Furthermore, if half of profits after tax were distributed, the 70% shareholder would be taxed roughly in accordance with his marginal rate, but the 30% shareholder would still be doubly taxed.
8. For an eloquent defense of the classical case, see Goode (1951, ch. 3).
9. For a discussion of recent empirical research in this area, see Cnossen (1983). The best economic treatment of the double taxation issue is McLure (1979).
10. This conclusion is supported by the findings of Baumol et al. (1970) who show that the return on new equity (and debt) is considerably higher than the return on retained profits. For empirical research that the classical system encourages profit retention, see King (1977, pp. 166-203), Feldstein (1970, pp. 57-72), and Fisher (1970, pp. 149-178).
11. In the tax literature this is viewed as the most serious shortcoming of the classical system. Thus, Gordon and Malkiel (1980, pp. 132-192) conclude that the welfare losses of a "highly levered capital structure (are) large and unpredictable". See also Stiglitz (1973) and (1976). For research that confirms the hypothesis that the classical system increases the cost of equity, see King (1977, pp. 222-227) and Tambini (1969, pp. 185-222).
12. Drawing on earlier work (1962), Harberger (1966, pp. 107-117) estimated the welfare costs of the differentially higher tax on equity in the United States at 0.5% of GDP. Shoven (1976, pp. 1261-1283) arrived at a figure of 0.3%. For a different view, see Bradford (1981).

rations whose returns on equity are taxed differentially higher, because the two opposite flows affect different forms of business organization.

Fifthly, and lastly, the distortions of payout rates, debt-equity ratios, and the juridical forms in which business may be carried on, may also have indirect detrimental effects on the level and especially the quality of national savings and investment. Savings and investment in the corporate sector are stimulated, but the effect on the economy's overall rate of capital formation may well be adverse.[13]

C. Full integration

The economic distortions caused by the classical system should not occur in a full transparent, competitive world in which the corporation tax would be integrated with the income tax of shareholders. The corporation would then serve only as a conduit, a pass-through, of corporate source income which would be taxed fully at the appropriate marginal income tax rate in the hands of shareholders. Example 2 illustrates the workings of full integration. For income tax purposes it is irrelevant whether and how much a corporation distributes of its profits. Retained as well as distributed profits are fully taxed according to the partnership method, that is, they are allocated in proportion to each shareholder's holding in the corporation's equity. The corporation tax is simply a prepayment for the income tax. It follows, of course, that effective rates are equal to respective bracket rates; there is no overtaxation.

Example 2
Full integration

A.	*Corporate level*		($)
	1. Profits before corporation tax		300
	2. Corporation withholding tax: 50% (1 × 2)		150
B.	*Shareholder level*		
	3. Income tax rate	30%	70%
	4. Attributed profits (1)	300	300
	5. Income tax (3 × 4)	90	210
	6. Corporation withholding tax (2)	150	150
	7. Net income tax (5 − 6)	−60	60
C.	*Combined tax burden*		
	8. Total tax (5 or 2 + 7)	90	210
	9. Effective tax rate (8 ÷ 1)	30%	70%
	10. Overtaxation [(9 − 3) ÷ 3]	0%	0%
	11. Tax relief [(classical overtaxation − 10) ÷ classical overtaxation]	100%	100%

Full integration is one of the normative implications of the accretion concept of income.[14] Its advocates point out that ability-to-pay, being an equity notion, can only be related to natural persons. It follows that if income is chosen as the best index of that ability, the equal treatment rule requires that income should be defined all-inclusive. For tax purposes there should be no difference between corporate profits and other capital income, such as interest and rents, or labor income, such as wages and salaries, that is solely subject to the individual income tax. There is no place, therefore, for an extra tax on distributed profits nor, it should be added, for the preferential treatment of profits retained by the corporation and taxed below the marginal income tax rate of shareholders.

Full integration of retained as well as distributed profits has been proposed by the Royal (Carter) Commission in Canada, the U.S. Treasury (Blueprints), and the Campbell Committee in Australia. Both under the voluntary and mandatory plans, all corporate source income would be included in the income of shareholders, while a full credit would be permitted for the corporate tax paid on their behalf. To prevent double taxation of retentions, the basis for corporate shares would be written up by the amount of retained profits. These plans, however ingenious, have never left the drawing board, primarily because they are considered impractical. Thus, it has been pointed out that full integration would be costly to the treasury, that delays in completing corporation tax assessments would have repercussions on the filing of shareholders' income tax returns, that it would be difficult to deal with different types of equity, that an undesirable side-effect might be that preferential income items would be passed through to shareholders, and last but not least, that shareholders might have to pay additional income tax, although no cash had in fact been received.[15] Except for small, private corporations that resemble partnerships, full integration does not (yet) appear feasible. It remains a useful benchmark, however, against which other systems may be judged.

III. INTEGRATION SYSTEMS

Full integration has been characterized as the search for a perfect solution in an imperfect world. Yet at the same time it has been considered important to eliminate or mitigate the economic distortions of the classical system. As a halfway house to the ideal, various partial integration systems have been introduced under which at least distributed profits can be taxed in accordance with the shareholder's marginal income tax rate. These dividend relief systems are discussed in this section. As in Example 1 (classical system) and Example 2 (full integration), the illustrations are based on profits before corporation tax of $ 300 and a corporate tax rate of 50%. It is assumed that the intention is to provide dividend relief for all shareholders at a rate of 40% measured against the classical overtaxation in Example 1. Integration systems at corporate level are dealt with first, followed by integration systems at shareholder level.

A. Integration at corporate level

The most obvious approach to the double-taxation issue is to permit dividends as a deduction from taxable profits, just like interest is. An alternative would be to tax

13. For empirical work, see Feldstein (1973), Feldstein and Flemming (1971), but especially Feldstein and Frisch (1977, pp. 37-52) and Fullerton et al. (1981, pp. 677-691).
14. For an exposition of the accretion concept of income, which goes back to George Schanz, Robert Murray Haig, and Henry Simons, see Cnossen (1982) and Goode (1976, ch. 2; and 1977).
15. For an exhaustive treatment, see McLure (1979, ch. 5), but reference is also made to Royal Commission (1966), Blueprints (1979), and Campbell Committee (1981) discussed in Swan (1983).

distributed profits at a lower rate. The dividend-deduction system and the split-rate system are analyzed in turn.

1. Dividend-deduction system

As shown in Table 1, dividend-deduction systems are mainly a Scandinavian phenomenon. In Finland, 60-100% of distributed profits are deductible in computing taxable profits. In Norway the percentage is 55% and Sweden's corporation tax has a deduction for 70% of dividends paid (but not more than SEK 700,000) up to an annual maximum of 15% of share capital. Denmark had a similar system before it adopted the imputation method in 1977. Greece allows profit distributions to be deducted in full subject, however, to withholding rates ranging from 45-53% (depending on the nature of the shares and whether they are quoted on the Athens Stock Exchange) which approximate the corporation tax rate of 48.5%.

Example 3 shows the workings of the dividend-deduction system. To provide 40% dividend relief two fifths of profits marked for distribution should be made deductible in determining taxable profits. It is possible, of course, to vary the degree of dividend relief. A full deduction makes the system equivalent to an undistributed profits tax with which the United States briefly, and not altogether favorably, experimented in the late thirties. A small deduction moves the system closer to the classical corporation tax.

Example 3
Dividend-deduction system

A.	*Corporate level*		($)
1.	Profits before corporation tax		300
2.	Dividend deduction (2/5 × 1)		120
3.	Profits before corporation tax (1 − 2)		180
4.	Corporation tax: 50% (3 × 4)		90
B.	*Shareholder level*		
5.	Income tax rate	30%	70%
6.	Dividend income (1 − 4))	210	210
7.	Income tax (5 × 6)	63	147
C.	*Combined tax burden*		
8.	Total tax (4 + 7)	153	237
9.	Effective tax rate (8 ÷ 1)	51%	79%
10.	Overtaxation [(9 − 5) ÷ 5]	70%	13%
11.	Tax relief [(classical overtaxation − 10) ÷ classical overtaxation]	40%	40%

A variant of the dividend-deduction system which has long been popular in Scandinavia and is still in use in Sweden limits the deduction to a so-called normal or primary dividend, say, equal to the interest paid on treasury bonds. At least in name, the corporation tax may then be labeled an excess profits tax. Substantial difficulties are involved, however, in determining the base on which the relief must be computed. Equity capital placed and paid up has only historical significance. Certainly, it does not represent the amount that shareholders have paid for the acquisition of their holding. Another base, namely equity for tax (book) purposes (including retained profits and reserves), implies that the primary dividend is calculated by reference to an accounting item which may differ markedly from the market value of equity. The relief is then an arbitrary reduction of the corporation tax rate which varies with the (accounting) relationship between the business' equity and its total worth. In the tax literature this unusual form of dividend relief has been called an inducement to the "survival of the fattest" because it favors businesses with relatively large equity.[16]

Furthermore, it has been proposed to limit the relief to dividends paid on newly issued shares. Thus, a 1979 draft of the American Law Institute suggests a limited deduction at the corporate level for dividends on new equity as well as a corporate excise tax on redemption in order to achieve a more even handed treatment between dividend and interest payments. An able lawyer who compared the proposal to the imputation system, however, concluded that the latter was "preferable in theory and workable in practice".[17] And, of course, there is always the danger that old equity will be liquidated and converted into new issues.

An important disadvantage of the dividend-deduction system is that the relief is automatically extended to foreign shareholders who do not pay the (additional) national income tax incurred by domestic shareholders. To prevent this the dividend withholding tax for profits transferred abroad might be raised, but experience in Germany has taught that it is nearly impossible to get such an increase incorporated in existing or new treaties for the prevention of double taxation. Another possibility is to disallow the deduction for dividends paid to (foreign) shareholders who are not subject to the national dividend withholding tax. This does not require a renegotiation of treaties. It is the route followed by Sweden. A final objection to the dividend-deduction system is that the corporation tax cannot serve as a means to verify the correct return of dividend income for the income tax. But its major advantage, of course, is that dividends are clearly treated at par with interest.

2. Split-rate system

The split-rate system is found in Austria, Japan, and Portugal. The Portuguese system is the most straightforward as distributed profits are simply exempted from the 12% surtax. Austrian and Japanese practices are more complicated. In Austria, the precise lower rate depends both on the amount of taxable profits and the dividend distribution. Presumably, the rate is lower if the payout rate is higher. And in Japan the split-rate depends on the degree of capitalization, the number of business offices in a prefecture, and the amount of profits. Most of the published experience with the split-rate system deals with the pre-1977 German system.[18] Just as under the dividend-deduction system, it has been proposed in the literature to limit the lower rate to a so-called normal or primary dividend, or, more generally, to a specified part of distributed profits. Of course, if the rate differential is small the split-rate system resembles the classical corporation tax, and if the differential is large it again becomes an undistributed profits tax.

16. Chown (1971, pp. 11-14). The 3¼% equity deduction introduced in the Netherlands in 1981 resembles the primary dividend deduction system.
17. See Warren (1981, pp. 719-800) commenting on American Law Institute (1979).
18. See Norr (1982), pp. 84-96.

Example 4 gives an illustration of a split-rate system that taxes distributed profits at a lower rate of 30%. Following, profits after corporation tax are distributed. At shareholder level they fall either in the 30% income tax bracket: $ 63 tax, or the 70% bracket: $ 147 tax. The combined liability (line 6) is $ 153 or $ 237 and the corresponding effective rates are 51% and 79%. If the degree of overtaxation is now compared to the overtaxation inherent in the classical system, then a dividend relief of 40% has been extended.

Example 4
Split-rate system

A.	*Corporate level*		($)
	1. Profits before corporation tax		300
	2. Corporation tax: 30% (1 × 2)		90
B.	*Shareholder level*		
	3. Income tax rate	30%	70%
	4. Dividend income (1 – 2)	210	210
	5. Income tax (3 × 4)	63	147
C.	*Combined tax burden*		
	6. Total tax (2 + 5)	153	237
	7. Effective tax rate (6 ÷ 1)	51%	79%
	8. Overtaxation [(7 – 3) ÷ 3]	70%	13%
	9. Tax relief [(classical overtaxation – 8) ÷ classical overtaxation]	40%	40%

A disadvantage of the split-rate system, apparent from the pre-1977 German experience, is that foreign parent companies with German subsidiaries could avoid the high split rate on retained profits by first distributing the subsidiary's earnings and then channeling them back for reinvestment. The effect should not occur if other countries, such as the United States, also levied corporation tax on profits transferred from Germany, while crediting the corporation tax paid in Germany. After all, the American Treasury would then recoup the difference between its tax and the German tax. But aside from the question whether this effect was intended by the German legislator, in turn it could be avoided by placing a Dutch or Swiss holding between the subsidiary and the parent. As a remedy, Germany attempted to negotiate increases of dividend withholding taxes on earnings transferred abroad, but this required changes in treaties already agreed to – always a laborious exercise.

B. Integration at shareholder level

As noted, there are two methods to integrate the corporation tax and the income tax at shareholder level: the dividend-exemption method and the imputation method. EEC arrangements are discussed separately.

1. Dividend-exemption method

Under the dividend-exemption method all corporate source income, including profit distributions, is taxed at the normal corporation tax rate, but dividend income is fully or partially exempted from the shareholder's income tax. An optional full exemption is available in Greece, though made less attractive because of the high withholding rates at company level. If a Greek shareholder includes the dividend in income, however, he is still granted an exemption of Drs. 25,000 per company, subject to a maximum of Drs. 100,000. Similarly, in the United States, the first $ 100 dividend income is exempt and this amount is raised to $ 200 for joint returns. In the Netherlands a partial exemption of Dfl.500 (Dfl. 1,000 for dividends received from participation trusts) was introduced in 1981 provided the dividend is received from domestic sources. And in Canada the first $ 1,000 capital income (dividends and interest) is exempt.

Example 5 shows the arithmetic of the dividend-exemption method. Clearly a serious objection to this form of integration is that the dividend relief is distributed regressively with respect to income. As the example makes clear a dividend relief from classical overtaxation of 40% for the shareholder in the 70% bracket corresponds to a relief of only 8% in the 30% income tax bracket. Essentially, the goal of dividend relief – the prevention of double taxation – is mixed up with the objective of progressivity – tax increases that rise proportionately faster than income. Unless the income tax is levied at a proportional rate, therefore, the dividend-exemption method must be rejected as an inequitable, unstructured relief. The concession should be granted in equal measure to each shareholder. Mitigation of income tax progression – possibly a laudable objective – should be judged on its own merits.

Example 5
Dividend-exemption method

A.	*Corporate level*		($)
	1. Profits before corporation tax		300
	2. Corporation tax: 50% (1 × 2)		150
B.	*Shareholder level*		
	3. Income tax rate	30%	70%
	4. Total dividend income (1 – 2)	150	150
	5. Exempt dividend income	26	26 a)
	6. Taxable dividend income (4 – 5)	124	124
	7. Income tax (3 × 6)	37	87
C.	*Combined tax burden*		
	8. Total tax (2 + 7)	187	237
	9. Effective tax rate (8 ÷ 1)	62%	79%
	10. Overtaxation [(9 – 3) ÷ 3]	108%	13%
	11. Tax relief [(classical overtaxation – 10) ÷ classical overtaxation]	8%	40%

a) The exempt dividend income has been computed by assuming a total combined tax liability of $ 237 in the 70% rate bracket (line 8), equal to the liability in the other examples. The corresponding income tax at the rate of 70% can then be calculated, as well as the taxable and exempt dividend income. Following, the same amount of exempt dividend income has been taken for the shareholder in the 30% bracket, which in turn forms the basis for computing the combined tax figures for this bracket.

This verdict applies also to proposals named after the French Minister of Finance, Monory, that permit a deduction from income of a specified net amount spent for the purchase of (new) shares.[19] In France this relief appears hardly to have had any influence on the volume of new share issues or on the number of shareholders, particularly if it is considered that 75% of all new shareholders preferred investments in participation trusts, or so-called Sicav's-Monory. Moreover, small and medium-sized companies usually do not benefit from this kind of measures. Just like the dividend exemption and the equity deduction, measures of the Monory type combat

19. For a description see Van 't Hoff (1983).

symptoms rather than contribute to a lasting, structural improvement of the investment climate. Because they are not as comprehensive, partial, selective measures are seldom as efficacious as a direct, general elimination of the double tax itself.

2. Imputation system

No doubt the imputation system is the most important form of dividend relief. In the period 1962-1977 seven out of 10 EEC member countries introduced this system, as did Canada and Turkey. In the EEC economic rather than equity considerations played an important role in the decision. Foremost among these were the desire to promote profit distributions in order to stimulate stock markets, and to a lesser extent, to reduce the tax-induced preference for the corporate form of doing business. The fact that the relief was not automatically extended to foreign shareholders gave most countries a new grip on their international tax rights and obligations. The interest in the imputation system was also stimulated by a 1975 draft directive of the European Commission.[20]

As shown in Example 6, imputation is achieved by requiring the shareholder to gross up his net dividend of $ 150 (line 4) with the corporation tax: $ 60, attributable thereto. The grossed-up dividend of $ 210 is then added to his other income and subjected to the progressive income tax. Following, the gross tax: $ 63 or $ 147 (line 7), is credited with the corporation tax with which the net dividend was grossed up in the first place. The balance represents the net tax payable (or refundable). Imputation, therefore, has the same gross-up and tax credit features as a dividend withholding tax. Also, it provides the tax administration with a similar means of checking the income tax return for the proper filing of dividends. The withholding technique works as an anti-evasion device because nationals holding stock through nominee accounts do not benefit from the relief. In passing it may be noted that imputation without gross-up would make the system's effect similar to that of the dividend-exemption method: the relief would be distributed regressively with respect to income.

Example 6
Imputation system

A.	*Corporate level*		($)
	1. Profits before corporation tax		300
	2. Corporation tax: 50% (1 × 2)		150
B.	*Shareholder level*		
	3. Income tax rate	30%	70%
	4. Net dividend (1 – 2)	150	150
	5. Imputed corporation tax (2/5 × 4)	60	60
	6. Dividend income (4 + 5)	210	210
	7. Income tax (3 × 6)	63	147
	8. Tax credit (5)	60	60
	9. Net income tax (7 – 8)	3	87
C.	*Combined tax burden*		
	10. Total tax (2 + 9)	153	237
	11. Effective tax rate (10 ÷ 1)	51%	79%
	12. Overtaxation [(11 – 3) ÷ 3]	70%	13%
	13. Tax relief [(classical overtaxation – 12) ÷ classical overtaxation]	40%	40%

3. EEC arrangements

The tax credit under an imputation system may be expressed as a percentage of the corporation tax (showing the extent to which the double tax is mitigated), as a percentage of the net dividend (indicating the legal form of the dividend relief), and as a percentage of the gross dividend (representing the comparable tax-inclusive income tax rate). As shown in Table 2, most EEC countries that provide relief have introduced a partial imputation system, generally with a tax credit for approximately half of the corporation tax.[21] Only Germany permits full imputation, at least if regional taxes (Gewerbesteuer) are not taken into account. In Ireland and the United Kingdom, the tax credit, expressed as a percentage of gross dividend, equals the basic rate of income tax. A tax assessment is then not required if taxpayers' other income is also subject to the basic rate. All countries, except Belgium which views the relief as an affair that concerns the corporation tax only, give a refund to individual shareholders if the tax credit exceeds the gross income tax liability. On the other hand, exempt corporate entities, such as pension funds and educational and charitable institutions, are not entitled to a refund, except in the United Kingdom.

Because they do not want to provide a tax credit for profit distributions on which national corporation tax has not been collected, 4 out of 7 countries in Table 1 levy a compensatory tax on dividends paid out of earnings that are wholly or partially exempt from corporation tax, such as profits remitted from abroad, earned under a tax incentive scheme, or arising in the form of lower taxed capital gains. Alternatively, as in Ireland, the tax credit is reduced or denied. In France the compensatory tax applies also to profits retained longer than 5 years even though corporation tax has already been paid thereon at the full rate. In the United Kingdom, the withholding tax for the "mainstream" corporation tax, called advance corporation tax (ACT), has been assigned the role of compensatory tax, because the offset is limited to 30% of a corporation's taxable profits. Three countries do not levy a compensatory tax. Denmark abolished the tax because its application was so limited that it was not considered worth collecting.

The compensatory tax is levied on corporations and credited to invividuals at a rate equal to the imputation credit attached to gross dividends. This means that countries with a partial imputation system nevertheless permit a full credit with respect to dividends distributed out of exempt profits. In other words, the aggregate tax burden on ordinary corporate source income is higher than the burden on exempt income which is only taxed at the shareholder's marginal rate of income tax (ignoring foreign tax, if any). Although the imputation system is meant to promote profit distributions the compensatory tax, of course, forms an inducement to retain exempt

20. See Commission of the European Communities (1975). The draft directive was sent back for further consideration by the European Parliament (1979). Parliament argued that it made little sense to harmonize tax rates as well as the treatment of profit distributions so long as, possibly large, differences in the rules for computing taxable profits continued to exist between member countries.

21. This and the following paragraphs draw heavily on Cnossen (1983, pp. 93-95).

Table 2
Imputation Systems in EEC Member Countries, 1983

Country (Year of introduction)	Corp. tax rate	Tax credit as percent of: Corp. tax[a)]	Net dividend	Gross[b)] dividend	Refund: Individual	Exempt entity	Compensatory tax and ordering rules
Belgium (1962)	45	49.9	40.8[c)]	29	No	No	No
France (1965)	50	50	50	33⅓	Yes	No	Yes
U.K. (1973)	52	39.6	42.9 (3/7)	30	Yes	Yes	Yes
Ireland (1973)	50	42.9	42.9 (3/7)	30	Yes	No	Yes
Germany (1977)	56/36[d)]	100	56.3 (9/16)	36	Yes	No	Yes
Denmark (1977)	40	37.5	25	20	Yes	No	No
Italy (1977)	30[d)]	83.3	35.7	26.3	Yes	No	No
EEC Commission (1975)	45-55	36.8-67.2	45-55	31-35.5	Yes	Choice	Yes

Source: Updated from Sijbren Cnossen, "The Imputation System in the EEC", in *Comparative Tax Studies: Essays in Honor of Richard Goode* (Amsterdam: North-Holland, 1983), Table 4.1.

a) If the tax credit as a percentage of the net dividend (the usual legal form) is r and the rate of corporation tax is t, then the tax credit as a percentage of the corporation tax is
$r.\frac{(1-t)}{t}$.
Net dividend includes normal withholding tax, if any.

b) If the tax credit as a percentage of the net dividend is r, then the tax credit as a percentage of the gross dividend is
$\frac{r}{1+r}$
Net dividend includes normal withholding tax, if any.

c) In Belgium the tax credit of 51% is expressed as a percentage of dividend net of withholding tax of 20%.

d) Statutory rate, excluding local corporation taxes. For total standard rates, see Table 1.

profits in the corporation as a means to minimize the corporate tax liability. Also, to the extent exempt profits are distributed, the tax nullifies the intended effect of tax holidays and other tax incentives.

Countries with a compensatory tax must provide rules for the sequence in which profits are presumed to be distributed. In order to mitigate the effect of the compensatory tax, profits that have been subject to the highest rate of corporation tax are generally deemed to be distributed first when dividends are paid. In addition, in France and under the directive, current profits are presumed to be distributed before retained profits, and among retained profits the oldest profits are deemed to be paid out first. In Germany profits are allocated to three accounts: profits to which the 56% rate has been applied, profits that have been subject to the 36% rate, and profits fully exempt from tax. Profits subject to an intermediate rate must be apportioned between a higher- and a lower-rated account. Of course, countries that do not levy a compensatory tax do not need ordering rules.

In most countries domestic corporate portfolio shareholders are treated the same as individual shareholders, i.e. they are permitted to deduct the tax credit attached to dividends received from other companies from their own corporate tax liability. In Germany, the lower rate on distributions implies that an additional 20% tax is charged on the receiving company, if the dividend is not passed on to individual shareholders. In fact, the introduction of the imputation system made the old "affiliation privilege" for domestic companies obsolete. Ireland and the United Kingdom exempt all intercompany dividends in the hands of receiving companies. Under these countries' legislation, however, the tax credit on such "franked investment income" slumbers and may be used to offset the compensatory tax payable upon redistribution of that income to individual shareholders. That arrangement applies also in other countries, e.g. France, that exempt dividends received from subsidiary companies under an affiliation privilege. The use of such a privilege is necessary because if imputation is partial, deduction of the tax credit attached to a subsidiary's dividend from the parent's tax liability would result in a higher aggregate corporate tax liability than if the total profit had been wholly earned by the parent company.[22] "Affiliation" may be loosely defined as in Belgium, or more substantively as in France where a parent-subsidiary relationship exists if the parent owns 10% or more of the paid-up capital of the subsidiary.

No country permits foreign shareholders to share automatically in the relief. France and the United Kingdom, however, extend the tax credit on a bilateral basis

22. Assume a rate of corporation tax of 50% half of which is grossed up and credited if profits are distributed. Then, if an affiliation privilege would not apply, a parent and its subsidiary have to pay $ 62 tax on each $ 100 profits before tax earned by the subsidiary and paid out to the parent. Of course, this does not make sense.

to portfolio investors in a number of countries.[23] Thus, under its double taxation agreements France provides an additional payment (which is generally subject to withholding tax) to foreign shareholders who, in turn, make the appropriate gross-up adjustment with respect to the individual or corporate income tax liability in their country of residence. As regards Germany, France makes a direct payment to the German government and German shareholders in French companies apply the regular gross-up and credit procedure. In a few countries corporate portfolio shareholders receive a refund of the compensatory tax, if any, that has been paid by a French distributing company; in that case, however, shareholders are not entitled to the tax credit. Generally tax credits are not granted with respect to foreign direct investments. Only the United Kingdom has concluded a few treaties under which profits on such investments, when remitted, are entitled to a tax credit at half the rate available to portfolio shareholders.[24]

IV. SUMMARY AND EVALUATION

The appropriate place of the corporation tax in an equitable and efficient tax system plays an important role in the tax debate in most OECD member countries. Should corporations be taxed as such or should their earnings be allocated to shareholders? If full integration is not feasible, is integration of the corporation tax on distributed profits a second-best alternative? If so, should dividend relief be provided at corporate or at shareholder level? How much weight should be given to the international repercussions of partial integration? And above all, even if some form of integration appears desirable in theory, are the transition costs worth the trouble?

A. Summary of findings

In an equitable tax system the case for a separate corporation tax (classical system) is at best uneasy. Surely, corporations have independent legal existence, as well as a capacity to pay tax in the sense that the corporation tax does not force them into bankruptcy. But the conclusion that they also have ability-to-pay is a non sequitur.[25] The incidence of all taxes, whatever their name and form, is always on natural persons. The search for the answer to the question of who bears the tax burden must start and end with individuals of flesh and blood. The more nearly tax burdens are imposed on them in line with the ability-to-pay principle and government's redistributive objectives, the better the tax system is.

Also the corporation tax does not appear a particularly efficient tax. There are strong indications that the tax distorts the optimal functioning of the capital market because it (a) stimulates the retention of profits, thus interfering with competitive conditions and hampering investments of new firms; (b) discriminates against equity by treating interest favorably compared to dividends, thereby inducing firms to rely more heavily on debt finance with its attendant increased risk of bankruptcy; (c) distorts the most efficient allocation of capital between the corporate and the noncorporate sector of the economy; and (d) provides firms with an inappropriate preference for the corporate form of doing business. Empirical research shows that the efficiency losses arising from distortions of the debt-equity ratio are the largest.

The equity shortcomings and economic distortions of the classical system, therefore, appear to point the way to integration. Full integration and retention of the corporation tax as a withholding device – to protect the workings of the income tax and to levy tax on foreign companies whose shareholders do not fall under the national income tax – does not appear feasible. Partial integration or dividend relief is a viable alternative, however, as evidenced by the experience of 14 OECD member countries. Moreover, it has been pointed out that full integration might then in practice be achieved if the top marginal rate of the income tax would be set at the same level as the corporation tax rate. Shareholders in low-income tax brackets would then push for profit distribution, while high-income shareholders would not benefit from profit retention.[26]

If payout rates would not be influenced by the choice of the integration system, the degree of dividend relief can be made the same under a dividend-deduction system, a split-rate system, and an imputation system. (The dividend-exemption method is clearly inferior because of its regressive aspects). Either system distributes the tax on distributed corporate source income more systematically in line with marginal individual income tax rates than the classical system. If the objective is to stimulate the stock market, relief at the shareholder level would seem most appropriate. If the goal is to increase the liquidity position of corporations (as an indirect investment incentive), a dividend-deduction or split-rate system might be called for. An advantage of the imputation system is that it does not automatically extend the benefit of dividend relief to foreign shareholders. Also because it functions as a withholding device, imputation should further taxpayer compliance with the income tax.

It should be noted that the case for or against integration

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23. The following treaties have been concluded:
a. *Denmark:*
   – portfolio investment: Australia, United Kingdom.
b. *France:*
   – portfolio investment: Austria, Belgium, Finland, Germany, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom, United States;
   – refund of compensatory tax: Canada, Denmark, Greece, Ireland, Italy, Japan, Norway, Portugal.
c. *Ireland:*
   – portfolio investment: United Kingdom.
d. *United Kingdom:*
   – portfolio investment: Austria, Denmark, Finland, France, Ireland, Luxembourg, Netherlands, Norway, Spain, Sweden, Switzerland, United States;
   – direct investment: Denmark, Luxembourg, Netherlands, Norway, Switzerland, United States.

Source: Bank Mees & Hope (1980).

24. The half rate is based on the argument that the credit should be extended only to non-resident direct investors to the extent earnings are redistributed to individual shareholders. Since it is estimated that approximately one half of corporate profits are so distributed, the tax credit for direct investments has been set at half the credit for portfolio shareholders.

25. An alternative, and better, rationale views the corporation tax on retained profits as a proxy for taxing capital gains accruing to shareholders. For a general treatment, see Head (1984).

26. For this "integration-by-the-back door", see McLure (1979, pp. 219-223).

is not contingent upon the assumption made with respect to the incidence of the corporation tax. If, as some argue, the tax is borne by consumers (in the form of higher prices) or workers (in the form of lower wages either immediately or, more likely, in the long run through the reduced availability of capital), it should be considered an inferior sales tax or payroll tax: inferior because its burden distribution varies arbitrarily from one corporation to another depending on the ratio between profits and sales or between profits and payrolls. Of course, there is no rationale for such taxes in an equitable tax system. Similarly, the efficiency case for integration does not depend on incidence assumptions.[27]

B. Transition issues

Dividend relief, like other tax changes, cannot be imposed on a de novo basis. Changes in the existing tax burden distribution, transition costs, and revenue effects must be accounted for. In classical countries, shareholders have long become accustomed to the system and it is likely that the tax, including its double levy, has been capitalized in earlier years in the form of reduced share prices. In other words, the tax has been borne by original shareholders who are not necessarily the same persons as present holders. Removal of the tax would then result in unwarranted windfall gains to existing shareholders. But the adage that an old tax is therefore a good tax does not legitimate this original sin, because distorting effects linger on.

If it is considered desirable to eliminate the distortions of the classical system but to maintain approximately the same burden distribution with respect to taxes on corporate source income, compensation for the loss of progressivity (and revenue) under any of the dividend relief systems might be found in the area of capital gains taxation. Dividend relief would result in a rise in share prices equal to the capitalized value of the increase in corporate source income after tax. It would appear equitable to tax present shareholders on this windfall gain when realized. An increase in the corporation tax rate would not be the appropriate instrument unless, as in Germany, imputation would be partially effected at the corporate level through a lower rate on profit distributions. This is so because the rate increase would imply a higher tax burden for corporations whose behavior is primarily determined by the amount of profits after corporation tax. A drawback of this proposal is, of course, that it is difficult to introduce capital gains taxes in a piecemeal fashion. A beginning might be made with gains on substantial holdings.

The international implications of dividend relief is another issue that must be considered. It is often contended that the classical approach – in conjunction with the nondiscrimination rule and reciprocity in dividend withholding tax rates on profits remitted abroad – discriminates less against international capital flows than the integration systems. The dividend-deduction or split-rate system should unduly favor foreign investors, and imputation should discriminate against them.

The imputation system, against which most of the ire is directed, may interfere less with capital export neutrality, however, than appears to be the case at first sight. Thus, some countries do not levy a compensatory tax (and exempt foreign dividend income from corporation tax). Neutrality is then achieved to the extent that profits are distributed if the effective rates of corporation tax in the source and resident country are the same. In other countries a compensatory tax is imposed, but foreign profits are presumed to be distributed last when it comes to the payment of dividend. Again distortions may be minimal if companies have the proper mix of domestic and foreign investment income. Furthermore, the tax on outgoing profits may be partially relieved through the application of a lower rate, as in Germany. More importantly, however, double taxation agreements can be an effective instrument in extending tax credits across national boundaries. As the expanding treaty network shows, reciprocity of tax credits for foreign portfolio shareholders is rapidly becoming the rule among industrial countries. In fact, there is a striking parallel here with dividend withholding taxes whose discriminatory effects on international capital flows have also been substantially eliminated through double taxation agreements.

C. Conclusion

A classical system imposes a tax burden on corporate source income that may be detrimental to attracting capital and adversely affect investment, productivity, and income. If it is decided to reduce that burden – a question to which this paper does not address itself – the best measure would be one that at the same time eliminated or mitigated some of the distortions of the present system. There is a presumption that dividend relief, and especially imputation, is to be preferred in this respect to a simple reduction of the corporation tax rate, although that would also work in the right direction. Even within the context of maintaining the current overall yield and progressivity of the tax system, I believe that a balanced, well-designed, imputation system would make a positive contribution to a more rational, equitable, and efficient distribution of the tax burden.

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27. For the equity argument, see Musgrave and Musgrave (1980, p. 401) and for the irrelevancy of the incidence issue for efficiency, Mieszkowski (1972). For a good survey of the views and findings on corporation tax incidence, see Ballentine (1980).

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APPENDIX

Equivalence of Integration Systems[28]

Let

- P = total corporate profits before distributions and corporation tax.
- P' = profits available for distribution before corporation tax and before dividend deduction under dividend deduction system.
- t = uniform corporation tax rate.
- t_u = corporation tax rate on undistributed profits.
- t_d = corporation tax rate on distributed profits.
- D = net (cash) dividend under split-rate system and dividend deduction system.
- D' = net (cash) dividend under imputation system.
- G = grossed-up dividend under imputation system.
- q = dividend deduction as a proportion of P'.
- r = tax credit as a proportion of D'.
- s = weighted average marginal income tax rate of shareholders.
- T = total corporation tax and income tax on corporate source income.
- $E = \frac{T}{P}$ = effective tax rate on corporate source income.

Then the following equations hold for the various integration systems:

1. *Split-rate system*

$$P' = D + t_d.P' = \frac{D}{1 - t_d}$$

$$E = \frac{t_u(P - P') + t_d.P' + s.D}{P} \qquad (1)$$

or after substituting $\frac{D}{1 - t_d}$ for P'

$$= \frac{t_u.P + [s - \frac{t_u - t_d}{1 - t_d}]\,D}{P}$$

2. *Dividend-deduction system*

$$P' = D + t\,(P' - q.P') = \frac{D}{1 - t\,(1 - q)}$$

$$E = \frac{t\,(P - q.P') + s.D}{P}$$

or after substituting $\frac{D}{1 - t\,(t - q)}$ for P'

$$= \frac{t.P + [s - \frac{t.q}{1 - t\,(1 - q)}]\,D}{P} \qquad (2)$$

3. *Imputation system*

$$G = D' + r.D'$$

$$D' = \frac{G}{1 + r}$$

$$E = \frac{t.P - r.D' + s.G}{P}$$

or after substituting $\frac{G}{1 + r}$ for D'

$$= \frac{t.P + [s - \frac{r}{1 + r}]\,G}{P} \qquad (3)$$

The effective tax rate on corporate source income under the various integration systems is the same if equations (1), (2) and (3) are the same, that is, if:

a. $t_u = t$, that is, the corporation tax rate on undistributed profits under the split-rate system is the same as the uni-

28. The preparation of this Appendix has benefited from earlier unpublished work by Sato and Bird (1975).

form corporation tax rate under the dividend-deduction and the imputation system;

b. $D = G$, that is, the net (cash) dividend under the split-rate system and the dividend deduction system is the same as the grossed-up dividend under the imputation system; and

c. $$\frac{t_u - t_d}{1 - t_d} = \frac{t.q}{1 - t(1-q)} = \frac{r}{1+r}$$

or after substituting t_u in t and isolating in t_d, the corporation tax rate, t_d, on distributed profits under the split-rate system is equal to $t(1 - q)$ under the dividend-deduction system and also equal to $t(1 + r) - r$ under the imputation system.

N.B. It should be noted that the most important assumption underlying this result is that payout rates are not affected by the choice of the integration system. This will be the case if corporate managers attach equal weight to taxes at corporate and shareholder levels. If they would consider the tax saving at the corporate level more important, then the payout rate under the split-rate system and the dividend-deduction system might be higher than under the imputation system. Furthermore, it is assumed that shareholders under all integration systems are subject to the same average marginal income tax rate weighted in proportion to the total shares outstanding held by each shareholder.

Alternative approach

Under the *split-rate system* in force in Germany before 1977 the corporation tax on distributed profits was regarded as undistributed profits and taxed as such. If the nominal rate on distributed profits is t'_d, it follows that the effective rate on distributed profits, t_e, can be determined as follows:

$$t_e.P' = t'_d.P' + t_e\,(t_u - t'_d)\,P'$$

or after eliminating P' and isolating in t_e

$$t_e = \frac{t'_d}{1-(t_u-t'_d)} = \frac{t_u-(t_u-t'_d)}{1-(t_u-t'_d)} \qquad (4)$$

Under the *dividend deduction system*, the dividend deduction, q, can, of course, also be expressed as a proportion of D, or as q'. Since per definition $q.P' = q'.D$, after substituting P' in

$\dfrac{D}{1-t(1-q)}$, it follows that $q = \dfrac{q'(1-t)}{1-t.q'}$

The effective rate $t_e = t\,(1-q)$ on distributed profits can then be rewritten as:

$$t_e = \frac{t-t.q'}{1-t.q'} \qquad (5)$$

Similarly, under the *imputation system*, the tax credit, r, can be expressed as a proportion of G, or as r'. Since per definition $r.D' = r'.G$, after substituting D' in

$\dfrac{G}{1+r}$, it follows that $r = \dfrac{r'}{1-r'}$.

The effective rate, $t_e = t\,(1 + r) - r$ on distributed profits can then be rewritten as:

$$t_e = \frac{t-r'}{1-r'}. \qquad (6)$$

The effective rates on distributed profits under the various integration systems should then be the same if (4) = (5) = (6), or if:

$$\frac{t_u-(t_u-t'_d)}{1-(t_u-t'_d)} = \frac{t-t.q'}{1-t.q'} = \frac{t-r'}{1-r'}.$$

This equivalency holds if:

a. $t_u = t$, as shown above; and

b. $t_u - t'_d = t.q' = r'$, that is, the difference between the corporation tax rate on undistributed profits and the corporation tax rate, t'_d, on distributed profits under the split-rate system is equal to the product of the uniform corporation tax rate and the dividend deduction as a proportion of the net (cash) dividend under the dividend deduction system and also equal to the tax credit as a proportion of the grossed-up dividend under the imputation system.

Morocco:

Tax Incentives for Foreign Investment

By Servaas van Thiel

Servaas van Thiel is research associate at the International Bureau of Fiscal Documentation. The author is indebted to Mr. Jean-Marc Tirard of Ernst & Whinney, France, for his kind advice and suggestions for improvement. The sole responsibility for this article rests, however, with the author.

1. GENERAL INTRODUCTION

The positive attitude of the Government of Morocco to foreign investment is reflected in the investment legislation which was passed in 1973 and partly renewed in 1983. Separate Investment Codes exist for the encouragement of investment in industry (1983), artisan or handicraft activities, maritime shipping, tourism (1983), mining, exporting, real estate and agriculture.[1] The benefits granted under these Codes are wide and particularly aimed at the creation of employment for local workers, the transfer of specialist skills and technology and the development of certain areas of the country.

The Moroccan Government also embarked in 1973 on a policy of indigenization, i.e. "Moroccanization" of certain economic activities. The result has been that specially indicated activities may only be exercised by Moroccan individuals or legal entities. However, the 1983 Codes removed all restrictions on industrial and tourist investments (the two most important areas) and the definition in other Codes of "Moroccan legal entity" still leaves room for foreign minority participation. Apart from these restrictions, the benefits under some of the Investment Codes are only granted to Moroccan enterprises, although the policy in this respect is changing.

2. MOROCCANIZATION

The Moroccanization policy resulted in 1973 in a series of laws[2] prescribing that certain activities may only be exercised by Moroccan individuals or legal entities. The term "Moroccan individual" is not further defined but it may be assumed that it means any person having Moroccan nationality.

A Moroccan company is defined as a company that has its seat in Morocco and fulfills the following criteria:

- For a joint stock company (société anonyme): at least half of the capital must be owned by Moroccan individuals or Moroccan public legal entities, and the majority of the members of the supervisory board as well as the chairman thereof and, where appropriate, the managing director must be Moroccan individuals.
- For a "civil partnership" or "general civil partnerships" (société civile ou société en nom collectif): all partners must be Moroccan individuals.
- For limited partnerships (sociétés en commandite): all general partners must be Moroccan individuals and must hold at least half of the authorized capital.

The activities to be carried on exclusively by Moroccans mainly concern trade, certain light industries, banking and insurance. A few days after the introduction of the Dahir-Law of 7 May 1973 these activities were divided into 2 groups. Non-Moroccans who engaged in the activities enumerated in List 1 had to comply with the Dahir-Law at the latest by 31 May 1974, i.e. they had to discontinue their activities no later than that date. The term for activities contained in List 2 expired one year later. In order to facilitate indigenization the Minister of Finance created a special "Indigenization Fund" to finance loans (maximum duration 10 years at 5%) to Moroccans who took over the foreign interests in activities reserved to Moroccans

Violations of the indigenization provisions are subject to investigation by any judicial policy official or special agent and are punishable by imprisonment for a period between 1 and 6 months and by a fine of 2,000 to 10,000 dirhams. In such a case the establishment is to be closed.

Apart from these restrictions on foreign investment, benefits under some of the Investment Codes are only granted to Moroccan enterprises but this policy is changing. The 1973 Industrial Investment Code defined a Moroccan manufacturing enterprise as an enterprise engaged in production, belonging either to Moroccan individuals or to companies at least 50% of the capital of which was held by Moroccan individuals or legal entities. The 1983 version of the Industrial Investment Code, however, eliminated this requirement, and so has the

1. Dahir-Law No. 1-82-220 of 17-1-1983 relating to industrial investment, Official Journal No. 3664 of 19-1-1983.
Dahir-Law No. 1-8-134 of 3-6-1983 relating to investment in tourism, Official Journal No. 3685 of 15-6-1983.
Dahir-Law No. 1-73-409 of 13-8-1973 relating to artisan investment, Official Journal No. 3172 of 15-8-1973.
Dahir-Law No. 1-73-408 of 13-8-1973 relating to investment by industrial and artisan export enterprises, Official Journal No. 3172 of 15-8-1973.
Dahir-Law No. 1-73-410 of 13-8-1973 relating to investment in shipping, Official Journal No. 3172 of 15-8-1973.
Dahir-Law No. 1-73-412 of 13-8-1973 relating to investment in mining, Official Journal No. 3172 of 15-8-1973.
Dahir-Law No. 1-69-25 of 25-7-1969 relating to investment in agriculture, Official Journal No. 2960 bis of 29-7-1969 and Dahir-Law No. 1-81-207 of 8-4-1982 relating to real estate investment, Official Journal No. 3572 of 15-4-1981 will not be discussed here.

2. Dahir-Law No. 1-73-210 relating to the carrying on of certain activities incorporated in Dahir-Law No. 1-73-339 of 7-5-1973 modifying Dahir-Law No. 1-73-210 relating to the carrying on of certain activities. Official Journal No. 3158 of 9-5-1973.
Decree No. 2-73-220 of 8-5-1973 implementing Dahir-Law No. 1-73-339, Official Journal No. 3185 of 9-5-1973.
Legislation implementing financing of Moroccanization of certain activities, Official Journal No. 3182 of 24-10-1983.
Arrêté No. 931-73 of 5-9-1973 concerning non-Moroccans exercising certain activities, Official Journal No. 3180 of 10-10-1983.

1983 version of the Tourist Code. The requirement still exists for benefits granted to artisan investment (only available to Moroccan individuals or companies held for 100% by Moroccan individuals or legal entities), to shipping investment (only available to Moroccan individuals or companies held for at least 50% by Moroccan individuals or legal entities) and mining investment (only available to Moroccan individuals, cooperatives, public bodies specializing in mining activities and companies at least 50% of the capital of which is held by Moroccan individuals or legal entities authorized under the Mining Law). For additional benefits granted to investment by industrial and artisan enterprises in order to encourage export, the situation as outlined in the 1973 Export Code is not clear. The Code refers to the Industrial Investment Code and the Artisan Investment Code so it can be expected that definitions of those Codes apply, but with regard to industrial investment it is not clear from the text whether the definition of the 1973 or 1983 version applies.

3. Application and approval procedures

There is no general system of industrial or investment licensing in Morocco. Therefore, no prior approval of investment is necessary. However, an application for approval is necessary in order to obtain the incentives granted under the various Investment Codes.[3] In general, new investment programs (10 copies) as well as modifications thereof have to be filed with the competent Minister[4] in order to decide whether the conditions mentioned in the various investment laws are satisfied. Only the benefits granted to export-oriented industrial and artisan undertakings are granted automatically.

The relevant Minister will, within 30 days, declare whether the investment program is in conformity with the Investment Code and send copies of the investment programs to the Prime Minister and the administration concerned with granting the incentives. The "conformity statement" does not waive other authorization or registration conditions which may be required.

If the Minister considers the investment not in conformity with the prescribed conditions, he will send his reasoned decision to the investor. If the investor has not received an answer within 30 days he can inform the Prime Minister's office and expect an answer in the following 30 days.

Apart from the "conformity statement", the granting of certain benefits requires an additional decision by a special Commission[5] or a special agreement concluded between the investor and the State, which lays down conditions of a technical and economic nature relating to the implementation and utilization of intended investments.

4. INVESTORS ELIGIBLE FOR INCENTIVES

The various Investment Codes define qualifying enterprises in different manners.

Industrial investment

Any industrial enterprise or enterprise which is connected with industry, including companies providing industry-related services, may benefit from the advantages provided for in the Industrial Code. An industrial enterprise is defined as an enterprise that uses capital goods for manufacturing and has an investment program that covers production equipment to a minimum of 100,000 dirhams. The enterprise has to submit the investment program to the Ministry of Industry for approval and must enter into an agreement with the State. Moreover, the investment project must be completed within 24 months from the date of issue of the certificate of approval, although extensions of this time limit may be allowed by the Ministry of Industry, in the case of large projects or *force majeure*. For the purpose of this Code the country is divided into 4 zones[6] and most incentives are only granted to industries located outside the Casablanca region. Eligible for additional incentives, specified by special agreement with the State, are industrial undertakings investing more than 50 million dirhams.

Artisan investment

Only artisan manufacturing establishments which are fully owned by Moroccan individuals qualify for benefits under the Artisan Investment Code. The investment may not exceed 5,000 dirhams for each new job. The investment program has to be submitted for approval and incentives for investments exceeding 5 million dirhams may only be granted under an agreement with the State.

Export-oriented investment

Artisan and industrial enterprises carrying on certain expressly specified activities are eligible for benefits additional to those already granted under the Industrial and Artisan Investment Code. The activities mainly concern the production of building materials, of rubber and chemicals including plastics, and of electronics and precision instruments, food processing, clothing, paper and the printing industry. The additional benefits are granted without further conditions.

Shipping investment

Eligible for incentives under the Maritime Investment Code are Moroccan individuals and at least 50% Moroccan-owned companies investing in vessels and fishing boats. Investment programs are to be submitted for approval to the Minister for the Merchant Navy.

3. Decree No. 2-73-413 and No. 2-73-408 of 14-8-1973 relating to filing of investment programs, Official Journal No. 3172 of 15-8-1973.
4. The competent authority for industrial and tourism investment is: the Minister for Trade, Industry and Tourism; for artisan investment: the Minister of Artisan Affairs; for shipping investment: the Minister for the Merchant Navy and for mining investment: the Minister for Mines.
5. Decree No. 2-73-407 and 2-73-410 on the functioning of the Commission as instituted by Dahir-Law 1-73-410 and 1-73-412 relating to mining and shipping investment, Official Journal 3172 of 15-8-1973.
6. Zone 1 is the Casablanca region, zone 2 is around the Casablanca region and zones 3 and 4 divide the rest of the country. See for detailed determination of the regions the list added to the 1983 Industrial Investment Code.

Investment in tourism

Eligible for incentives granted under the Tourist Investment Code are all "tourist enterprises", the definition of which covers enterprises engaged in the construction or reconstruction, fitting out or management of all places for the accommodation and entertainment of tourists, transport enterprises and tourist agencies. The places for accommodation of tourists have to fit into the existing classification and the places for entertainment have to be part of a tourist complex.

Investment programs are to be submitted for approval and have to be completed within 36 months following such approval. Extension of the time limit by 24 months is possible for transport enterprises and other extensions are possible in the case of large projects or *force majeure*. Withdrawal of incentives is possible if investment programs are not implemented in accordance with their object. Finally, the ownership of places for the accommodation of tourists enjoying benefits under the Code cannot be transferred, without approval of and without meeting the conditions specified by the administration, for a period of 10 years.

Eligible for additional incentives which are specified by special agreement with the State are tourist enterprises investing more than 60 million dirhams.

Investment in mining

"Mining entrepreneurs" are eligible for incentives under the Mining Code. They include Moroccan individuals, co-operatives, public bodies specializing in mining activities and companies at least 50% owned by Moroccans or authorized legal entities.

In general, investment programs have to include at least 100,000 dirhams worth of plant and machinery used for prospecting and production.

Investment exceeding 500,000 dirhams in plant and machinery for processing of minerals and providing employment for at least 50 persons is eligible for State aid for infrastructure provided that the investment proposals are submitted for approval to the Minister for Mines.

5. INCENTIVES

Although there are different investment codes for various economic sectors, the incentives granted under these codes are similar. They include exemptions from various duties and taxes, beneficial loan terms and guaranteed transfer of capital and dividends.

Incentives common to all codes will be indicated first and special benefits or conditions are listed thereafter. Incentives under the Industrial Code are not always granted for investments in the Casablanca region.

1. *Exemption from customs duties* (droits de douane) on all authorized imports of equipment, machinery and plant, unless these goods can be manufactured and supplied locally. Goods imported duty-free must be used in accordance with their purpose for a minimum period of 5 years. The exemption does not apply to shipping investment and applies to industrial investment only if it is made in certain regions outside the Casablanca area. Refunds of duties already paid are possible.

2. *Exemption from the product tax* (taxe sur les produits) on all locally purchased or imported equipment, machinery and plant. Refunds of duties already paid are possible. The exemption does not apply to shipping investment.

3. *Reduction of the ad valorem registration duty* (droit d'enregistrement) on capital contributions in respect of the creation of a company and increases in capital to 0.5%.

4. *Exemption from the tax on business profits* (impôts sur les bénéfices professionnels) for the first 10 years. For shipping and mining investment no exemption exists but it is possible to include in deductible charges, for the purpose of calculating the tax base, accelerated depreciation on fixed assets to a maximum of double the rate generally allowed. The exemption is replaced by a 50% deduction for industrial investment in certain areas and for tourist investment. However, tourist investment in certain provinces and in tourist agencies benefits from total exemption. All artisan and tourism investors benefit from accelerated depreciation of fixed assets when they expand activities.

5. *Guaranteed remittance* of initially invested capital and dividends to non-residents.

6. *Reduction of interest rate* to 2% on loans received from authorized credit institutions (5% for artisan enterprises and 4% for certain tourist enterprises).

Additional benefits are provided for in various Codes. For *industrial investment:* the new 1983 Code provides during a period of 7 years for the annual refund, upon export, of the amount of the special tax (taxe spéciale) which has been paid. It also provides for an exemption of stamp duties on the issuance of shares. Moreover, purchases of land by industrial enterprises outside the Casablanca area are exempt from registration duties provided that the land is used within 24 months and provided that a first mortgage is given to the State as security for payments due if the former condition is not met.

Up to 50% of the cost of land in certain regions, depending on the number of jobs created, will be borne by the State provided that the land is situated in special industrial zones.

Furthermore, industrial undertakings may form an investment fund, exempt from business profits tax, for investments in certain regions. The maximum annual amount is 20% of trading profits and investment out of the fund must take place within certain time limits.

Furthermore new industrial undertakings outside the Casablanca area are exempted from the trade tax (l'impôt des patentes) for 5 years. Additional incentives are also granted to small and medium-sized industries (i.e. industrial undertakings investing less than 5,000,000 dirhams and not more than 70,000 dirhams per permanent post) in the form of a 5,000-dirham premium for the creation of a permanent post (minimum 1 year) for an employee.

The central Government pays a premium on imports of machinery or equipment saving energy or water or the environment.

Finally, for large investment projects exceeding 50,000,000 dirhams any other incentive can be negotiated on a case-by-case basis.

For *artisan investment* there is an exemption from the license duty for a period of 5 years.

Exporting industrial and artisan enterprises are entitled to an annual allocation in foreign currency of 3% of export turnover, for marketing research, foreign agencies and publicity.

For certain types of *shipping investment* an investment allowance can, upon advice of a special commission,[7] be granted to a maximum of 15%.

Additional allowances are granted for investment in certain types of new vessels. Vessels in respect of which allowances have been given may not be sold without authorization of the Minister of the Merchant Navy and Sea Fishing. If sold within 5 years the allowances must be paid back.

For *mining investment* there is an exemption from the trade tax for a period of 5 years. Moreover, mining entrepreneurs investing more than 500,000 dirhams in the working and processing of mineral substance – thereby creating employment for at least 50 persons – are entitled to financial aid for infrastructure, up to 50% of infrastructure costs. Such aid is conditional upon approval by a special commission and may not exceed 15% of total investment. Investors in large mining ventures exceeding 30 million dirhams may negotiate other incentives on a case-by-case basis.

Additional incentives for *tourist investment* include an exemption from stamp duties on the issuance of shares and an exemption from the trade tax for a period of 10 years. Also exempted from stamp duties are acquisitions of land provided that it will be used within 24 months and provided that it will be mortgaged to the State to ensure payment of sums due if the first condition is not met.

Moreover, investors are entitled to a refund of turnover taxes paid on the construction or reconstruction of places for tourist accommodation and restaurants.

Finally, enterprises engaged in the construction or reconstruction of places for tourist accommodation and entertainment (except those classified as 5 stars) are entitled to a 10-year interest-free loan of 15% of total investment (calculated as total expenses minus exemptions from taxes and import duties). For those enterprises located in specified areas the loan is raised to 20% of total investment for a period of 12 years. The loans are granted by the Government's Crédit Immobilier et Hôtelier (CIH).

7. See note 5.

SIERRA LEONE:

Budget 1984-85

A Harsh Budget

Extracts from the Budget Speech pronounced by the Hon. Salia Jusu-Sheriff, M.P., Minister of Finance, on 29 June 1984.

Revenue

63. There was significant improvement in the collection of revenue from Customs and Excise and Direct Taxes during the 1983/84 Fiscal Year. However, our performance on other revenues which includes dues, licences, fees and receipts from investment collectable by Government Ministries and Departments fell short of our projections.

Customs and excise

64. Customs and Excise continue to be the most important single source of our revenue and contribute nearly 60% of its total. On the basis of the ten months actual performance in 1983/84, collection from this source recorded Le. 134 million, an increase of roughly 45% over 1982/83. This level of collection was achieved even though the bulk of our imports comprising essential food items are not dutiable and the fact that imports by foreign diplomatic missions, international organisations and charitable organisations accounting for a substantial volume of total imports are allowed in duty free. In the area of excise duties, there was significant improvement inspite of the very severe foreign exchange constraints imposed on the importation of raw materials for the manufacturing sector.

65. At this juncture, Mr. Speaker, Honourable Members, I would like to take this opportunity to record my appreciation to the Comptroller of Customs and Excise and his staff for their fine performance. I do hope that they would imrove on this record in 1984/85. In our bid to improve performance in that Department, Government recently appointed a Customs and Excise Advisory Committee. The main function of the Committee will be to assist the Comptroller of Customs and Excise in monitoring the valuation and inspection of goods entering our harbour and airport. This is an area which my Ministry has been studying very closely and I believe the creation of this committee will minimise the incidence of leakages and evasion at the Customs which have deprived Government of substantial revenue. For 1984/85, revenue from Customs and Excise, excluding Sierra Leone Produce Marketing Board is estimated at Le. 146 million, showing an increase of about 23% over 1983/84.

66. The Sierra Leone Produce Marketing Board (SLPMB) continues to be an important contributor to Government revenue. On the basis of the projections of its exports in 1984/85 it is expected that Government would realise an export tax totalling Le. 24 million.

Direct taxes

67. Revenue collected from direct taxes by the Income Tax Department in 1983/84 amounted to Le. 55 million, an increase of 25% over the 1982/83 target. This amount could have been even higher but for tax exemption on resident employment income from Le. 820 to Le. 1,202. I would here again like to express my sincere appreciation to the Commissioner of Income Tax and his staff for a job well done and hope they will continue.

68. Mr. Speaker, Honourable Members, our projections for direct taxes in 1984/85 are estimated at Le. 66 million, an increase of 24% over 1983/84. The target we have set for 1984/85 is by no means an easy one but with determination and dedication, I have no doubt that we will achieve our goal.

Other revenues

69. The collection of revenues other than Customs and Excise duties and Direct Taxes by various Ministries and Departments will be kept under constant review. Mr. Speaker, I would like to observe in particular, that the Posts and Telecommunications Department, the Police Department, the Ministries of Mines, Agriculture and Internal Affairs are responsible for the collection of the bulk of these revenues. I would therefore like to urge officers in these Ministries and Departments to be more vigilant and to ensure that revenues in their respective areas are collected and accounted for.

. . . .

Tax proposals

76. Mr. Speaker, Honourable Members, this section of the Budget Speech is usually regarded as the core, and is undoubtedly the section which arouses the interest of everyone. During my last Budget Speech, I stated that I would lay emphasis during the financial year on the collection of existing revenue rather than on new measures, and as mentioned earlier, we did so. This year, however, I intend to make the following modest proposals together with more improvements in tax administration:

(i) Airport tax will be increased from Le. 10 to Le. 15 per passenger leaving Lungi Airport;

(ii) Import duty on foreign cigarettes will be increased to Le. 80 per kilo or 200% *ad valorem*.

(iii) Customs duty rate on imported potable spirit will go up as follows:

Item	*Present duty rate per litre*	*New duty rate per litre*
Whisky, Rum, Gin, Vodka and Brandy	(June, 1980) Le.14 or Le.10.64 per bottle	Le.16 or Le.12 per bottle

(iv) Motor Car Licences are increased in accordance with the following cubic capacities:

Cubic Capacity	*Increase*
1000 to 1999	Le.6
2000 to 2999	Le.9
3000 and over	Le.15

There has been no increase in this item since 1975.

77. In an effort to improve on revenue collection, Government will also examine and adjust the rates of fees charged for services such as business registration, external postal services, landing and parking fees for aircrafts, registration of legal instruments, trade marks and stamp duty.

THAILAND:

Taxation of Royalties, License Fees, Etc., Paid to Non-Resident Licensors

This note was prepared by Mr. M. Hongskrailers of Coopers & Lybrand Associates and Mr. K.S. Jap, principal research associate of the International Bureau of Fiscal Documentation.

A Working Paper which was presented at the 12th meeting of the Study Group on Asian Tax Administration and Research (SGATAR), 7-12 June 1982 in Kuala Lumpur, Malaysia, was reprinted in 37 *Bulletin for international fiscal documentation* 8 (1983) at 361-364. With respect to remittances of profit by way of royalties, license fees etc., the following was stated:

"One way to avoid paying high tax on profits is to remit profits in the form of royalties or license fees. Under present Thai tax law, royalties are subject to the 25% withholding tax whereas profits are subject to a 40% tax and another 25% tax on profit remittances. Moreover, royalties are considered as expenses of the company. Thus an MNC may arrange with its subsidiary to charge royalties or license fees at a higher rate or to charge a fee which normally would not be charged. If the royalty charge is ฿ 1,000,000, the tax on royalties is ฿ 250,000. However, the subsidiary may claim royalty expenses, thereby reducing the profit of the subsidiary by ฿ 1,000,000. The tax on this ฿ 1,000,000 is ฿ 400,000. Moreover, this ฿ 1,000,000 is transmitted to the headquarters without paying the 25% tax on remittance which amounts to 25/125 × 600,000 = ฿ 120,000. The total tax of the company on this ฿ 1,000,000 would be ฿ 520,000 if it were transmitted as profits. However, if it were disguised as royalties, the tax would be ฿ 250,000. Thus the MNC can save ฿ 270,000 through this arrangement. This practice does not conform to the arm's lenght principle and is against Thai tax law, as stated earlier.

Thailand has had another interesting experience concerning tax on royalties. In Thailand, the import of certain commodities is subject to a very high rate of customs duty and it pays the taxpayer to disguise part of the price of his imports in the form of royalties. For example, an item imported may be subject to a 70% customs duty. If the actual price at c.i.f. of the import is ฿ 1,000,000, the taxpayer may understate the price as being only ฿ 600,000 and claim that there is a royalty charge of ฿ 400,000. Thus customs duty paid is than ฿ 420,000 and tax on royalty ฿ 100,000. The taxpayer, then, pays a total of only ฿ 520,000 to the government. If part of the price was not disguised as royalties then that taxpayer would have had to pay the Government a total of ฿ 700,000. Thus, the taxpayer would save ฿ 180,000 through this arrangement. *Measures have already been taken to plug this loophole.*"

This note aims to set out the present effective regulations as published in the Official Gazette concerning the taxation of royalties paid to non-resident licensors.

Prior to these regulations, the Thai tax law provided that certain royalties were to be included in the value of the merchandise or goods fur purposes of assessing import duties and business tax (a kind of gross receipts tax) on such goods imported into Thailand. The import duties and business tax had to be paid in this manner by the importer at the moment the goods were imported. When, the licensee-importer pays the royalties to the non-resident licensor, the resident licensee must again withhold the income tax on the royalty payment and remit the amount of tax so withheld to the Revenue Department.

The importer of the goods into Thailand is liable for payment of customs duties and business tax on any royalties attached to such goods. The foreign licensor – being a company or other legal entity organised under foreign law and not carrying on a business in Thailand receiving royalties, license fees or other remuneration of a similar nature which is paid either from or in Thailand – is subject to corporate income tax under Section 70 of the Revenue Code.

The payer of the royalties must withhold income tax at the source at the rate of 25% of the gross amount of the royalties. If the non-resident licensor is an individual receiving taxable royalties in Thailand, the withholding tax at source is levied at the progressive rates of the personal income tax, ranging from 7% to 65% of the gross amount.

This view was first revealed in Customs Notification No. 15/2523 dated 28 August 1980.

The Department of Customs considers that certain royalties are to be taken as part of the market price of imported goods, in accordance with the definition in Section 2 of the Customs Act 1926 and Section 3 of the Customs Act 1959, as amended.

Royalties are defined as remittances in connection with imported goods or use of trademarks, names or brand names owned by licensors abroad.

The kinds of royalties which are to be included in the price of imported goods for assessment of customs duty are:
(1) royalties on finished products;
(2) royalties on goods imported for manufacturing, mixing, assembling or preparation of a finished product either (a) in a simple manner such as use of trademark, packing for retail of processing, or (b) assembling or mixing of the product;
(3) royalties on goods which form only part of the final product. In this case, a certain part of the royalties is to be included in the price of the imported goods for assessment, according to the ratio of the value of the goods imported to the value added by the additional manufacturing process to the point of a finished product.

Certain royalties are not regarded as being part of the import price to be included for assessment of customs duty, three instances of which are cited hereunder:
(1) when items imported are also generally available in the market;
(2) when the properties of the finished product do not depend on the use of the imported item but on operations within Thailand after importation;
(3) when the goods imported are used as a component which is not a material part of the finished product processed in Thailand.

As a procedure to ensure proper compliance with the regulations, importers are now to comply with three directives stated hereunder:
(1) submit any agreement, together with evidence of royalties payment, to the Price Evaluation Division on the Department of Customs;
(2) submit invoices with particulars of the royalties;
(3) give details about the royalties on the import forms or at least note that royalties have to be paid with particulars not yet available at the time of importation of the goods.

Because the Customs Department, prior to the Notification of 28 August 1980, did not make public earlier the rules concerning the inclusion of royalties in the price of the imported goods for the assessment of customs duties, there were many bona fide importers who were not aware of such type of assessment and thus did not include the royalties in the price of the goods at the time of importation but afterwards had duly paid the income tax on royalties at the rate of 25% as provided under the Revenue Code, Section 70, in connection with the charging Section 40(3) of that Code.

In view of protests made by multinationals and in order to avoid double taxation by various kinds of taxes on royalties, the Government issued two Royal Decrees and two Notifications on this issue which were published in the Official Gazette in Special Volume 98, Part 182 dated 3 November 1981.

Those statutes came into force as from 28 August 1980, the same date as Customs Notification No. 15/2523. The statutes adhere to the taxation set out in the Customs Notification. Those statutes involved are:
(1) Royal Decree issued in accordance with provisions of the Revenue Code governing the exemption from the revenue taxes (No. 114) of 1981 (this law provides the exemption from income tax on royalties);
(2) Royal Decree issued in accordance with the provisions of the Revenue Code governing the exemption from the business tax (No. 115) of 1981;
(3) Notification of the Ministry of Finance No. Saw. Kaw. 10/2524. Subject: reduction of the rate of customs duties.
(4) Notification of the Director-General of the Revenue Department on income tax (No. 18). Subject: Prescribing rules and procedures for the exemption of income tax under Section 70 of the Revenue Code with respect to the payment of royalties, copyrights or other rights.

In the Clarification of the Ministry of Finance re: Collection of Taxes and Duties respecting Royalties dated 25 November 1981, the Ministry of Finance set out the following general information to importers so as to ensure henceforth proper payments of taxes and duties with respect to royalties paid to non-resident licensors.

The term "royalties" under these statutes and notifications means royalties or other similar remuneration in cash or value in money payble by the importer to the sellers abroad or to third persons with respect to the:
(1) importation of goods for manufacture under an agreement;

(2) importation of goods under a trademark, name or brand name of the proprietors in foreign countries;
(3) import of goods without any trademark, name or brand name for the purpose of using the trademark, name or brand name of the proprietors in foreign countries after the importation, whether or not the payment is made before or after the importation and whether or not it is paid in a lump sum or by installments.

The present effective rules can be summarized as hereunder:

Goods imported prior to 28 August 1980 are exempt from customs duties and the business tax on royalties by virtue of Royal Decree No. 115 of 1981 and Notification No. 10/2524 in order to avoid unnecessary administrative work in the retroactive collection and refund of business tax and customs duties.

However, this exemption is granted only if income tax has already been paid and the following situations do not apply:
(a) where customs duties and business tax on royalties have already been paid;
(b) where there is an evasion of, or an attempt to avoid, customs duties and/or business tax;
(c) where there is a case with respect to an offense against customs law and the case has been finalized.

Goods imported on 28 August 1980 and afterwards are exempt from income tax on royalties by virtue of Royal Decree No. 114 of 1981 and Notification No. 18, but remain subject to customs duties and business tax on royalties at the moment of importation of goods. However, the Customs Department shall issue a Certificate of Payment of the Business Tax and Customs Duties and Royalties to the importer for use as evidence to be shown to the Revenue Department's Assessment Officer in applying for exemption from income tax when paying the royalties, or, in case income tax has already been paid, for use as evidence in applying for the refund of income tax from the Revenue Department.

In applying for the exemption from income tax, the taxpayer shall submit Income Tax Form 5C (Por. Ngor. Dor. 5 Khor.) together with the Certificate to the cashier of the Revenue Department. The taxpayer will receive a receipt in which is stated "no collection made" within 7 days from the last day of the month in which payment is made for use as evidence that Income Tax Form 5C has already been filed.

CONCLUSION

The result of the current Thai tax law on royalties and license fees paid to non-resident licensors effective from 28 August 1980 – as far as royalties, lease payments and license fees are attached to goods imported into Thailand – is the levying of import duty and business tax at the moment of importation and not income tax. The latter one can, but the two former cannot, be credited by the licensor against his world-wide income tax liability. From the international tax points of view, this will hamper the transfer of such goods to Thailand from abroad. In this respect royalties and license fees payable by a licensee in Thailand to a non-resident licensor could better be subject to the Thai income tax (Revenue Department) after importation of such goods rather than to the import duties and business tax (Customs Department) at the moment of importation of the goods. Requests and inquiries with respect to the possibilities of being subjected to the income tax in lieu of import duties and business tax on royalties, etc., payable by non-resident licensors can be obtained at the Duty Assessment Division, Customs Department, and the Legal Division, Revenue Department, Bangkok, Thailand.

BANGLADESH:

Some Highlights of the 1984–85 Budget

By K.A. Gofran

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See for a description of the Bangladesh tax system, *Taxes and Investment in Asia and the Pacific*, a publication of the International Bureau of Fiscal Documentation.

The Budget of the Government of the People's Republic of Bangladesh for the fiscal year 1984/85, as announced on 27 June 1984, envisages a net revenue receipt of 3,465 crore[1] taka and an outlay of 2902.80 crore taka, leaving a surplus of 662 crore taka, which will partially finance a 3896 crore taka Annual Development Programme. Presenting the Budget at the Old Assembly House, the Principal Finance Secretary and Adviser for Finance emphasized the need for socio-economic stability for success of the Budget for economic development and progress. He hoped that in 1984-85 uncertainties will gradually disappear and economic activities will be pursued, free from political controversy. According to the Principal Finance Secretary, the economy had emerged from the recession and was now poised for a period of growth. This was partly because of favorable changes in the external environment, but mostly due to the determined policy changes made by the Government. The growth rate would easily have exceeded 5% during the last year but for the latest natural disaster.

Optimism has been expressed in the Economic Survey accompanying the Budget that the Gross Domestic Product (GDP) will rise by 4.5% as against 3.7% in the preceding year. The Survey said that the agricultural sector made the highest contribution along with other sectors to GDP. Per capita income is also expected to rise by 2.3% to 2,086 Tk. at 1979/80 prices and to 3,306 Tk. at current price and Gross National Product to 30,563 crore taka.

The Principal Finance Secretary mentioned in his Budget speech that inflation has been contained and there is an upswing in trade. The Budget for 1984-85 is expected to provide a meaningful push to the process of economic growth next year. The Secretary disclosed that during the last two years inflationary expectations were contained by following a realistic interest rate policy, particularly in respect of the deposit rate. He announced measures for creating an incentive for banks to accept fixed deposits and to extend term lending. He also announced the details regarding disbursement of rural credit and their recovery. The Budget speech indicated a favorable balance of payments situation. At the end of June 1984, foreign exchange reserves were estimated at 1,300 crore taka (US$ 518,000,000).

THE NEW FISCAL MEASURES: THE FINANCE ORDINANCE, 1984

Direct taxes

The Principal Finance Secretary announced new financial measures to raise 103.80 crore taka to meet the gap in resources to finance 3896 crore taka ADP (Annual Development Programme) for 1984-85. The new measures and policy prescription have been formulated with a view to increasing agricultural and industrial production and stabilization of prices. These measures are also aimed at protection of domestic industry, safeguarding consumer interest, removal of fiscal anomalies, a uniform tariff on identical goods and simplification of the tariff structure.

This was the first time that no amendment relating to income tax law was proposed in the Finance Ordinance in view of the promulgation of the new Income-tax Ordinance which has been made effective from 1 July 1984. Amendments have, however, been made in respect of the Gift Tax Act, 1963 and the Wealth-tax Act, 1963 but these are a result of the promulgation of the Income-tax Ordinance, 1984.

Even though no amendment has been effected in the matter of income tax law, the Government announced certain relief and concessions in the Budget for salaried employees and other taxpayers, particularly registered firms and companies. These are:

(a) Enhancement of cash exemption of the house rent allowance paid by an employer from 1,800 Tk. to 2,000 Tk. per month.
(b) Exemption of the cash conveyance allowance granted by the employer has been raised from 3,000 Tk. to 3,600 Tk. and from 3,600 Tk. to 4,200 Tk. if certain conditions are fulfilled.
(c) Interest on the accumulated balance of an employee in a recognized Provident Fund is now raised from 12½% to 14½% as in a Government Provident Fund.
(d) For the purpose of deduction at source, income tax from indenting commission earnings[2] has been reduced from 10% to 5%.
(e) Registered firms were paying income tax at the highest rate on income exceeding 160,000 Tk. but to provide relief and for uniformity such firms will now pay tax at the highest rate on income exceeding 200,000 TK. as is done by individuals, unregistered firms and others.

1. 1 crore = 10,000,000.
2. Indenting commission is an earning from indenting of goods purchased from abroad. In a developing economy as that of Bangladesh foreign trade mostly consists of import of finished goods, raw materials and machinery which is to be procured from various manufacturers/suppliers, who pay their local agents a specified sum for purchase of the goods and other commodities in terms of foreign currency. This earning is repatriated through the Bangladesh Bank (Central Bank) and is converted into Bangladesh currency. Tax is deducted at source from this kind of earning. In the budget for 1984-85 the rate of deduction has been fixed at 5% instead of 10%, as applicable hitherto.

(f) Henceforth, "publicly traded companies" will be charged to tax at the rate of 45% as against 50% as at present, but in order to qualify as such companies there should be at least 5 shareholders on average for each one lac[3] taka of capital.

(g) At present, an income tax rebate is available on income from export sales up to a maximum of 60% of tax payable. Sales of locally manufactured machinery, equipment and other finished products to any agency against its procurement programme in foreign exchange covered under foreign aid, loan or grant will now be treated as export sales so that such sales would also become eligible for export rebate.

FOREIGN TRAVEL TAX ON JOURNEYS BY LAND OR BY SEA

By amendment of the Finance Act, 1980 provision has been made to levy and collect tax on all foreign travel by land or sea by Bangladesh nationals and Bangladeshis having a permanent residence in Bangladesh or owning property or a business in that country or enjoying other facilities not available to foreign nationals at the rate of 50 Tk.[4] per traveller by land and 200 Tk. per traveller by sea. This is effective from 1 August 1981.

AMENDMENT TO THE SALES TAX ORDINANCE, 1982

Amendments have also been effected to the Sales Tax Ordinance, 1982 to provide for certain facilities – such as drawbacks to importers – and to limit the period for claiming refunds, etc. In accordance with the Budget proposals of the Principal Finance Secretary, sales tax has been abolished on certain items like standby generators, raw wool, lifts and escalators.

LEVY OF SHOP TAX

The Principal Finance Secretary proposed that in order to augment internal resources a new tax – called the shop tax – be levied and collected from the owner, occupier or management of any shop situated in the Metropolitan Areas and in the Municipal Areas comprising district headquarters and in such other area or areas as may be notified in the Official Gazette by the National Board of Revenue. This provision shall not, however, apply to the districts of Chittagong Hill Tract, Bandarban and Khagrachari where mostly tribal people reside.

The National Board of Revenue has framed rules and has laid down procedures for levying shop tax which will be administered by the Taxes Department (IRD) of the Government.

AMENDMENT OF THE STAMP ACT, 1899

The Stamp Act, 1899 has been amended to discourage the practice of transferring properties by executing more than one instrument for paying duty at the lowest slab in the progressive rates. The amendment provides that where any property is conveyed to the same person in parts by separate instruments executed within 12 months, the last instrument shall be chargeable with such amount of duty as would make up the total ad valorem duty chargeable for the property.

EMBARKATION FEE

The embarkation fee for every outgoing passenger has been raised from 100 Tk. to 200 Tk. in order to bring the rate to a level comparable to other countries in the region and also to raise additional revenue. The domestic rate of 10 Tk. per passenger, however, remains unchanged.

The rates and schedules of income tax applicable for the fiscal year 1984-85 are shown in the Appendix.

APPENDIX

THE THIRD SCHEDULE

Rates of income tax

A. In the case of every individual, Hindu undivided family, unregistered firm, and association of persons and every artificial juridical person referred to in clause (46) of section 2 of the Income Tax Ordinance, 1984 (XXXVI of 1984), not being a case to which paragraph B applies:

	Taxable income (takas)	Rate
under	10,000	2.5%
	10,000–20,000	250 Tk. plus 5% of the amount exceeding 10,000 Tk.
	20,000–30,000	750 Tk. plus 10% of the amount exceeding 20,000 Tk.
	30,000–40,000	1,750 Tk. plus 20% of the amount exceeding 30,000 Tk.
	40,000–50,000	3,750 Tk. plus 30% of the amount exceeding 40,000 Tk.
	50,000–80,000	6,750 Tk. plus 40% of the amount exceeding 50,000 Tk.
	80,000–130,000	18,750 Tk. plus 50% of the amount exceeding 80,000 Tk.
	130,000–200,000	43,750 Tk. plus 55% of the amount exceeding 130,000 Tk.
over	200,000	82,250 Tk. plus 60% of the amount exceeding 200,000 Tk.

Provided that –

(i) no income tax shall be payable on a total income which before the deduction of the sums, if any, exempted under paragraphs 1 to 14, 17, 18 and 20 of Part B of the Sixth Schedule to the Income Tax Ordinance, 1984 (XXXVI of 1984), does not exceed 20,000 Tk.; and

(ii) the income tax payable shall in no case exceed:

(a) the amount by which the total income exceeds 20,000 Tk. or

(b) the amount representing 60% of the total income,

whichever amount is less.

3. 1 lac (or lakh) = 100,000.
4. This provision brings those persons holding dual or multiple nationality within the provisions of the Foreign Travel Tax as per Amendment to the Finance Act, 1981, Circular No. 6 (I.T.) of 1981.

Provided further that in the case of a person other than a company being resident in Bangladesh bringing income accruing and arising outside Bangladesh into Bangladesh through official channels, income tax shall be charged at the rate of 30% of such income or at the rate applicable to his total income including such income, whichever is more beneficial to him.

Explanation. The expression "taxable income", as used in this paragraph, means the taxable income as defined in clause (63) of section 2 of the Income Tax Ordinance, 1984 (XXXVI of 1984).

B. In the case of every company and local authority and in every case, under the provisions of the Income Tax Ordinance, 1984 (XXXVI of 1984), income tax is to be charged at the maximum rate –

(i) on the whole of the total income excluding the amount representing income from dividends from a company having its registered office in Bangladesh:

	Income	Rate
(a)	in the case of every industrial company not being a publicly traded company	45%
(b)	in the case of every industrial company not being a publicly traded company	50%
(c)	in the case of all other companies including banks and financial institutions and local authorities	60%
(d)	in the case of a person not being a company who is not resident in Bangladesh	30%

Provided that a rebate at the rate of 10% of the tax shall be allowed to a company registered in Bangladesh under the Companies Act, 1913 (VII of 1913) on so much of its income, profits and gains accruing or arising outside Bangladesh to which sub-section (4) of section 12 of this Ordinance does not apply as are brought by it into Bangladesh.

(ii) On the amount representing income from dividends declared and paid by a company formed and registered in Bangladesh under the Companies Act, 1913 (VII of 1913), or a body corporate formed in pursuance of an Act of Parliament in respect of the share capital issued, subscribed and paid after 14 August 1947 — 15%

Explanation. The term "publicly traded company" as used in this paragraph means a public limited company which fulfils the following conditions:

(a) it is an industrial company formed on or after 1 April 1984;
(b) the paid-up capital of the company is not less than 20 lacs taka;
(c) at least 50% of the paid-up capital of the company as at the end of the accounting year is subscribed by the shareholders other than the directors and sponsors of the company;
(d) no share of the company has been purchased in benami* by the directors and sponsors of the company;
(e) average ownerhip of shares of the company is at least 1 for each 20,000 Tk. of the paid-up capital;
(f) at least 10% dividend has been declared and distributed to the shareholders of the company out of the profit of the accounting year for which assessment is to be made; and
(g) the shares of the company are listed in a Stock Exchange before the end of the accounting year for which assessment is to be made.

IFA news

SWISS BRANCH

On 16 November 1984 the members of the Swiss Branch of IFA will meet in Bern. Dr. Theo Faist will briefly report on the first subject of the 1984 IFA Congress held in Buenos Aires (Fiscal obstacles to the international flow of capital between a parent and its subsidiary) and Dr. P. Bischofberger will comment on the second subject (Social security contributions as a fiscal burden on enterprises engaged in international activities).

The reports for the 1985 Congress in London will be officially presented and discussed during the meeting. The Reporter on subject I (The assessment and collection of tax from non-residents) is Dr. R. Truog and the Reporter on subject II (International double taxation of inheritances and gifts) is Maître P. Gillioz.

Mr. A. Digeronimo from the Federal Revenue Service will give a talk on the Bill for the creation of tax-free reserves for the creation of employment. The next meeting is planned for 9 February 1985.

C. In the case of every registered firm:

	Income (takas)	Rate
under	20,000	Nil
	20,000–30,000	10% of the amount exceeding 20,000 Tk.
	30,000–60,000	1,000 Tk. plus 15% of the amount exceeding 30,000 Tk.
	60,000–120,000	5,500 Tk. plus 20% of the amount exceeding 60,000 Tk.
	120,000–200,000	17,500 Tk. plus 25% of the amount exceeding 120,000 Tk.
over	200,000	37,500 Tk. plus 30% of the amount exceeding 200,000 Tk.

Provided that income tax shall not be payable by a registered firm in respect of the income, profits and gains derived by it from the exercise of a profession if such income, profits and gains depend wholly or mainly on the personal qualifications of its partners who are prevented by any law for the time being in force or by convention or rules or regulations of the professional association, society or similar body or which they are members to constitute themselves into a corporate body with a limited liability which can be registered as a company under the Companies Act, 1913 (VII of 1913), unless such profession consists wholly or mainly in the making of contracts on behalf of other persons or the giving to other persons of advice of a commercial nature in connection with the making of contracts.

Explanation. The term "registered firm", as used in this paragraph, means a firm registered under section 111 of the Income Tax Ordinance, 1984 (XXXVI of 1984).

* Editor's note: under the name of another.

Tax Reform in Jamaica The 1984–85 Budget

By H.W.T. Pepper

Mr. Pepper is a former tax inspector and Customs & Excise officer in the United Kingdom, advisor to various foreign governments (Brazil, British Virgin Islands (B.V.I.), Gibraltar, Guyana, Jamaica, Malaysia, Malta, Solomon Islands, St. Kitts-Nevis, St. Vincent-Grenadines, Seychelle Islands and Singapore).

1983-84 was an eventful year for Jamaica. There was a further fall in bauxite production, and inevitably a deficiency on revenue account. In December 1983, however, the Government of the Right Honourable Edward Seaga, P.C., M.P. was given a further 5-year lease of life and promptly took the bold move of devaluing the Jamaican dollar against the U.S. dollar from J$ 1.78 to J$ 4.00, roughly in line with the black market rate, so as more or less to wipe out the black market in foreign currency.

Jamaica's social and economic problems are immense. The birth rate is high, heading for a population of 3 million by the year 2000 which would be a disaster. Unemployment is running at a high level, about 26%, although the rate is less than that prevailing when the Seaga Government first took over in November 1980. Bauxite production has fallen from 12 million tonnes to 7.7 million because of world recession, although a turnaround is now hoped for; much food is imported although there is much idle land and labor, and Jamaica was once a major exporter of sugar and bananas.

The Civil Service is over-manned and there is much scope for better management in some areas of the public and private sectors. There is also need for tightening up on control of foreign exchange earnings, e.g. by the tourist industry, because Jamaica, like other developing countries, has great need of funds to purchase foreign equipment and know-how – the new Government is already tackling this and other problems.

As regards tourism, there has been substantial progress over the last 3 years, the figures for tourist visitors having increased from around 550,000 to nearly 800,000. There has been a build-up of stadia for musical festivals, Jamaican style, facilities for film-making in a warm sunny climate, and there is considerable research going on into the desirability and feasibility of installing a casino industry. The latter would produce healthy revenue and also expand tourism, but care would have to be taken to avoid any influx of criminal elements.

The Civil Services will be cut mostly in the kindest way by not replacing wastages of personnel through retirement or resignation, except where essential, and by re-structuring Departments.

One major plan is AGRO 21, the plan to revive agriculture after 21 years of Jamaican independence. The plan is basically to use "idle hands" to cultivate "idle lands" so that not only can Jamaica feed itself, but also export more agricultural produce. There is a wide range of products lined up, including fish and shrimps for pond culture, a scheme which is already under way; and new types of vegetables.

Apart from stepping up family planning work, moves have already been made to try to ensure that children do attend the schools provided for them. Another new scheme is to provide meal "factories" so that good lunches may be provided for pupils at a basic cost of 80c., which should improve health among the poorer classes; children will pay only 20c. for the meals, and much food will be distributed freely.

With a substantial devaluation, equally substantial changes have to be made to all specific duties, taxes, licenses, etc. These were effected either before Budget Day, or at midnight on the Day. Some changes (e.g. motor licenses), however, are scheduled for 1 July 1984. Changes in incidence have been introduced in respect of levies on the tourist industry, now able to bear a larger share of taxation.

Jamaica's indirect taxation on commodities, etc. is somewhat complex, but is soon to be simplified into a general consumption tax, a straightforward, but fairly weighty project which will, however, effect useful administrative economies for both the public and private sectors.

Jamaica's personal income tax regime is also somewhat complex with many types of reliefs and deductions, not all of which are compatible with each other, and the basic exemption limit is not very high.

A new approach is to be made, with a basic relief of J$ 5,000 and with other relief to all those whose income does not exceed J$ 6,999, and the matter will be discussed with the private sector, particularly the Institute of Chartered Accountants. These changes should also go a long way towards simplifying matters for taxpayers and their employers.

Altogether the Budget proposals tackle a mass of weighty problems in an eminently sensible way and should achieve very valuable administrative economies and improve revenue flow and general prosperity.

Budget 1984-85

Extracts from the Budget Speech delivered on 24 May 1984 by the Right Honourable Edward Seaga, P.C., M.P., Prime Minister, and Minister of Finance and Planning.

THE BUDGET DEFICIT

In this fiscal year 1984/85, government proposes to cut the budget deficit roughly in half to 8.3% of GDP.

To do so we are projecting revenue and expenditure as follows for 1984/85 as compared with 1983/84:

	J$M	
Revenue resources	1983/84 Out-turn	1984/85 Projections
Tax revenues	1501.42	2065
Non-tax revenues	76.16	171
C.D.F. (bauxite)	140.00	483
Total	1717.58	2719
Expenditures		
Current	2420.41	2840
(wages & salaries)	(967.00)	(1061)
(interest)	(785.60)	(1067)
(other)	(667.81)	(712)
Current deficit	−702.84	−121
Capital	630.74	665.4
("pass throughs")	(93.00)	*(88.4)
(other)	537.74	577.0
Over-all deficit	−1240.58	698
Financing		
Loans	1240.58	698
(external/net)	(400.74)	(567)
(domestic non-banks/net)	(221.1)	(131)
(banks)	(618.74)	

REVIEWING THE PUBLIC SECTOR

During the 1984/85 financial year, it is essential that as far as possible, there be no wastage in the public sector. To this end, the level of staffing of all ministries, departments and other public bodies is currently being carefully reviewed.

In areas where excess staff is found, every effort will be made to re-assign such staff to productive and useful work. Where this is not possible, however, there will be terminations of employment. In all such cases, the full benefits to which those affected are entitled will be paid.

Steps have also been taken to ensure that vacancies in the civil service are no longer automatically filled. A careful review of the importance of the tasks to be discharged and the feasibility of the duties being assigned elsewhere is undertaken before permission is given for any vacancy to be filled.

Also, where retirements are due, a process will commence of not filling any vacancies that will arise unless it is considered necessary to do so. These measures are expected to save some $ 69 million in the current financial year.

The government regrets having to institute this redundancy programme, but the necessity arises from the need to control the cost of government so that the level of borrowings to finance the budget will be manageable.

If we fail to do this, more and more of our resources will go to service greater and greater debt, leaving less and less for the educational, health and security services, as well as the development programmes of road construction, housing and water supplies which the country requires. Comparative studies have determined that the Jamaican Civil Service, in proportion to the population of the country, is the largest in the world.

TAXATION REVENUES

On the resourceside, the revenue resources this year to finance the budget are targeted to achieve a level of 32.5% of GDP. Of this amount, taxation revenue is projected at a level agreed with the IMF on 24% of GDP which is marginally higher than the 23.4% achieved in 1982/83, and 22.9% last year.

To achieve this level, a taxation package of $ 138 million has already been announced. I propose today to add to that $ 45.1 million as follows:

	J$M
Motor vehicle & drivers' licences	10.0
20% addition consumption duty on beer and spirits	23.1
$ 600 per room licence fee on hotels and villas	6.0
$ 2,000 per car licence fee on car rental agencies	4.5
$ 15,000 licence fee for each duty free shop $ 25,000 licence fee for the issue of a shop operator's licence and a shop operator agency permit	1.5
(These flat charges are in place of the present fee of $ 200 per shop of 3% of gross sales from which some $ 600,000 are now collected annually)	
Total	45.1

The consumption duty on beer and spirits commence as of midnight tonight, while the licence fees are all applicable as of July 1. A ministry paper tabled gives further details. All licence fees, it should be remembered, can be set off against income tax. Beer and spirits are now on an ad-valorem basis as a result of which it is the manufacturer who determines the mark-up.

INCREASED DUTIES

But as a guide to the public, I advise that the increased duties on these items are as follows:

Red stripe beer (12 oz. bottle)	7.5 Cents
Heineken beer	8.5 Cents
A drink of White rum	7.9 Cents
A bottle of Rum (Appleton)	$ 1.17
A bottle of Gin	$ 1.11
A bottle of Vodka (Spaskaya)	$ 1.13
A bottle of Whisky	
Local Whisky	$ 1.82–$ 1.87
Imported Whisky	$ 3.47–$ 4.67

The exsiting duties payable under the road traffic act on motor cars, motor cycles, motor trucks and tractors, and motor vehicle driver's licences will be increased effective from 1st July, 1984, as follows:

- Motor car licence duties will be increased by 50%.
  The licence duties on hackney carriage and contract carriage vehicles classified as motor cars will be increased from $ 73.50 per annum to $ 111.000 per annum irrespective of the cylinder capacity of the vehicle.
- Motor cycles licence duties will be increased from $ 16.50 per annum to $ 25.00 per annum.
- The existing level of licence duties on motor trucks and tractors which use petrol or diesel as fuel will be increased by 50%.
- For driver's licences the present licence duty of $ 8.00 per annum will be increased to $ 15.00 per annum.
- Provisional driver's licences will be increased from $ 5.00 for six months to $ 10.00 for six months.
  Increases in user fees will be done throughout the year.

REVENUE COLLECTIONS

Revenue collections so far this year have been 6% off target in April because some new taxes programmed for April had not yet been announced. The performance in May is nearly on target so far.

If revenues achieve the target of 32.5% of GDP set for this year, it can be expected that the revenue will hold that level through next year, which means that an objective of expenditure being reduced to 37% of GDP next year, we could attain in two years our goal of bringing the deficit down from an inherited level of 17% to roughly 5% of GDP.

If that is accomplished, it would not only be an outstandig performance, but we could then put behind us one of the two problems which continue to plague the economy, the alarmingly high level of the budget deficit; for at a deficit level of 5% of GDP, the economy could sustain the borrowing programme and the problem of over-borrowing to finance budget expenditure would be at an end.

I remind you that the budget deficit at that stage would be almost at the low level of 1972 when it was no more than 3.7% of GDP and the recovery process would be virtually complete in restoring budget financing levels to sustainable and manageable proportions.

TAX REFORM AND RELIEF PROGRAMME

Members of this Honourable House are aware that over the past two decades scant attention has been paid to the restructuring of the tax system necessary to fit changing economic policies and conditions. In particular, the tax system does not support Government's development policy of basing economic growth on private sector initiative and export promotion. Tax practices have distorted relative prices to the point of providing a serious constraint to economic growth, while on the managerial level the quality of tax administration has deteriorated to a point where an unacceptably small proportion of the tax base is being assessed.

Furthermore, inequities in the system provide strong incentives for tax evasion and avoidance with the result that in many instances in order to avoid the high marginal personal income tax rates the taxable income of employees is treated as non-taxable perquisites, and self-employed individuals outside the PAYE system often understate their incomes.

Government being fully aware of the deficiencies, initiated the Jamaica Tax Structure Examination Project in September 1983 with a view to effecting a comprehensive reform of the tax system. The purpose of this Project is to design and introduce a tax system which supports Government's economic recovery programme, as well as the structural adjustments through which the programme is being pursued. It is envisaged that the following objectives will be achieved through the modification or re-design of the tax structure in order to ensure that:

(i) the revenue contribution to the development of the economy is maximised;
(ii) all budgetary requirements are adequately financed;
(iii) the burden of taxation is equitably distributed, consistent with Government's long-term policy regarding the re-distribution of income and wealth;
(iv) additionally, the Revenue Services will be re-organised to ensure efficient and fair administration of the revised tax system. The this end, the Revenue Administration Bill which seeks to rationalise the assessment and collection functions of the Revenue Departments will shortly be presented to parliament.

The project which has two major components, namely, Tax Policy and Tax Administration is being conducted in two stages. In the first stage, a formal evaluation of the existing tax system vis-a-vis the expressed objectives of Government's economic programme will be conducted, and systems designed to correct deficiencies where they exist:

Preliminary evidence collected during the Design phase of the Project suggests that the existing system has certain characteristics that:

(i) discourage savings;
(ii) encourage capital flight;
(iii) subsidize relatively high capital intensive production methods at the expense of labour;
(iv) encourage imports; and
(v) discourage work-effort and economically viable production in the domestic market.

While there are other characteristics that mitigate some of these effects, it appears that the current tax system is an impediment to achieving higher levels of production, exports and employment.

The reform of the existing system will accordingly require intensive study of each of the following major components:

(a) Personal income tax and corporate taxation.
(b) Investment incentives.
(c) Foreign trade and domestic indirect taxation.
(d) Property tax and transfer tax.
(e) Special studies – distribution of the tax burden, elasticity of the system and impact on low income families.

The findings from the foregoing studies will be embodied in a White Paper which will set out in full the proposed reforms and the timetable for implementation. Members of the public as well as special interest groups including the Trade Unions, PSOJ, Institute of Chartered Accountants and the Chamber of Commerce will be given the opportunity to submit their views on the proposals. Thereafter, the proposals incorporating the recommendations of these bodies will form the agenda from which Government will draw in implementing the major tax reforms.

Satisfactory progress has been made so far in the studies relating to the new system of domestic indirect taxation based upon a General Consumption tax. This will be complementary to the restructuring of the income tax system in order to ensure revenue buoyancy and to minimise loss of revenue after implementation of the new systems.

Concurrently with the development of the general consumption tax is the re-design of the income tax system to take account especially of the restructuring of the personal tax rate schedule and the rationalization of the systems of tax credits and perquisites. To this end, employers are being required to submit schedules of emoluments which identify basic salaries as distinct from allowances and benefits in cash or kind receivable by employees. The analysis of the date will provide the basis for the development of a new personal income tax rate schedule with lower rates and wider income bands. In this regard, the interest group named above will also be afforded the opportunity of contributing their views.

The whole exercise is expected to be completed later this year for implementation early next year.

In the meantime, in order to relieve the burden on low-income earners as indicated in the recent Throne Speech, it is proposed to introduce measures which will in effect relieve individuals earning incomes of up to $ 5,000 from income tax and reduce the tax liability of individuals earning up to $ 6,999. An estimated 90,000 individuals will benefit. This relief takes effect from the year of assessment 1984.

UNITED STATES:

Options for Systems Replacing Worldwide Unitary Taxation

REPORT TO THE WORLDWIDE UNITARY TAXATION WORKING GROUP, PREPARED BY THE TREASURY DEPARTMENT'S OFFICE OF TAX POLICY, CONSIDERED AT THE WORKING GROUP'S MEETING OF 1 MAY 1984

This paper was prepared, at the request of the Task Force of the Worldwide Unitary Taxation Working Group, by the U.S. Treasury Department's Office of Tax Policy. While it describes the activities and developments that occurred within the Task Force, it does not necessarily reflect the particular views of individual Task Force members.

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INTRODUCTION

State governments in the United States have traditionally used formula apportionment methods to determine a particular state's share of the taxable income of a single corporation that operates across state borders. Under this method a share of the income of a single corporation considered to be engaged in a "unitary" business is attributed or "apportioned" to the taxing state on the basis of relative levels of business activity. If, for example, 10% of the corporation's total unitary business activities (generally measured by payroll, property, and sales) occur in a particular state, 10% of the corporation's total income would be subject to that state's corporate income tax.

This unitary apportionment method is used by all forty-five states that levy corporate income taxes to divide the taxable income of a single corporation operating across state borders. Roughly one-half of the corporate income tax states also use the unitary apportionment method to determine their share of the income of multi-company groups operating across state lines through subsidiaries. These states, in other words, apply an apportionment formula to the combined income and business activities of related U.S. corporations forming a unitary business. In turn, about one-half of these states that combine domestic corporations engaged in a unitary business also include foreign corporations that are part of a "unitary" business in the company's "combined report" of income. It is these twelve states that use the so-called worldwide unitary method of taxation.

Under this method, the income from related corporations, domestic or foreign, that are part of a "unitary" business is combined to determine the total income of the unitary corporate group. A share of this combined income is then assigned or apportioned to the unitary tax state on the basis of relative levels of business activity. If 10% of the total or worldwide business activities of the entire unitary business occur in a particular state, 10 percent of the group's worldwide combined income would be taxable by that state.

The alternative to the worldwide unitary method of taxation is separate accounting. It determines the income of commonly-controlled corporations on a corporation-by-corporation basis and does not take into consideration the income of affiliated corporations not doing business within the taxing jurisdiction. The separate accounting method allocates income among related corporations according to "arm's length" or unrelated party prices. The separate accounting method requires the price of transactions between corporations under common ownership to be set as if the corporations were unrelated. In the international context, this method is used by the federal government, by virtually all foreign governments with which the United States has an active trade or investment relationship, and by thirty-three of the forty-five states that impose a corporate income tax.

Multinational corporations and foreign governments allege that the worldwide unitary method of taxation leads to state taxation of foreign source income and is at variance with the internationally-accepted separate accounting method for avoiding double taxation. Foreign-based multinationals contend that use of the method imposes substantial administrative burdens because of the need to translate their entire foreign operations into U.S. currency and to conform them to U.S. accounting rules. Since U.S.-based multinationals must report their worldwide operations for federal income tax purposes, they express a lesser level of concern over the administrative problems perceived associated with worldwide unitary.

Proponents of the worldwide unitary method believe that it is the more accurate and fair way to measure the in-state income of multinationals. Since, they note, worldwide unitary combination is merely the logical extension of formula apportionment, as applied domestically, and formula apportionment is applied to small businesses, multinationals should be treated the same. The states believe that they should be free from federal interference in establishing their fiscal systems; their use of the worldwide unitary taxation method has been held constitutional by the U.S. Supreme Court. The states also contend that the separate accounting system permits multinational businesses to artificially shift profits from high to low tax jurisdictions. They further point out that separate accounting poses administrative problems for the states because of the difficulty of determining "arm's-length" prices.

In a June 27, 1983, decision, the U.S. Supreme Court upheld California's right to use the worldwide unitary method of taxation as applied to U.S.-based multinationals in *Container Corporation of America* v. *Franchise Tax Board*. In the wake of the *Container Corporation* decision, members of the business community and major trading partners of the United States renewed their objections to the worldwide unitary tax method and urged the Administration to: (1) file a memorandum with the Supreme Court as *amicus curiae* in support of a rehearing in the *Container Corporation* case; and (2) support federal legislation that would limit or prohibit worldwide combined taxation. Others, including state government officials and labor organizations, urged the Administration to oppose federal restrictions.

The Administration responded to these requests by establishing, in mid-July, a Cabinet Council on Economic Affairs (CCEA) Working Group to identify the federal and state government interests in the worldwide unitary method of taxation and to develop possible options. The CCEA study group was chaired by the Treasury Department and had representatives from the following departments and agencies: Council of Economic Advisors, Commerce, Housing and Urban Development, Justice, Labor, Office of Policy Development (White House), State, Transportation, and the U.S. Trade Representative. Based on that review, a series of options were developed and forwarded to the CCEA and the President for decision.

On September 23, 1983, Treasury Secretary Regan announced President Reagan's decision to refrain from filing a motion for rehearing in *Container Corporation* and to establish a Working group composed of representatives of the federal government, state governments and the business community. According to the Treasury Department News Release announcing its formation, the Group, chaired by Secretary Regan, was "charged with producing recommendations. . . that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states."

On September 30, Secretary Regan invited representatives of all groups involved in the states' use of the worldwide unitary method of taxation to an October 7th meeting to discuss the formation of the Working Group. The membership of the Working Group was announced by Secretary Regan on October 28 and the first meeting scheduled for November 2. . . .

WORKING GROUP AND TASK FORCE ACTIVITIES

The Worldwide Unitary Taxation Working Group held its initial meeting on November 2, 1983, in the Cash Room of the Treasury Department. Secretary Regan explained that the objective of the Group was to arrive at a consensus-based recommendation which he could convey to the President. After summarizing the issues presented by the use of the unitary method, Secretary Regan noted that "in the absence of a finding of a constitutional violation, under our federal system, states have wide latitude in the taxation of income unless explicitly restricted by federal legislation." However, he observed "the effects of the use of the worldwide unitary method may interfere with the foreign commerce of the United States, so this becomes a matter of vital federal interest." The Working Group discussed the relative merits of the worldwide unitary and separate accounting methods, its perceptions of the problem, the objections of foreign governments, and the concerns of interested parties. The Working Group established a staff of technical-level Task Force to thoroughly review the issues and develop options for decision by the Working Group.

The Working Group held its second meeting in the Treasury Department on December 6 and received a Status Report on the Task Force's activities. At that meeting, the Working Group reviewed perceived problems with both the worldwide unitary and separate accounting methods of taxation and instructed the Task Force to develop options for voluntary state action and to defer consideration of restrictive or preemptive federal legislation. The decision to defer consideration of federal legislation reflected a shared view by both the state and business members of the Working Group that a cooperative voluntary approach based on consensus offered the best choice of obtaining a solution to these difficult problems. Secretary Regan indicated that the Working Group would still be free to consider a federal legislative alternative if the Group failed to arrive at a suitable consensus.

A corollary of the Working Group's decision that the Task Force should defer consideration of a legislative solution was its agreement to give the Task Force a broad and comprehensive mandate, instructing it to consider the impact of the worldwide unitary method on U.S., as well as foreign-based multinationals. Summarizing the Working Group discussion, Secretary Regan said the Task Force "should examine the taxation problem in its broadest aspects, as regards multinational corporations, whether foreign or domestic. . . and the implications . . . on our international relationships. . . as well as on states' revenues and states' rights."

The Task Force of the Worldwide Unitary Taxation Working Group was composed of representatives of the Working Group members. . . . Since it was established by the Working Group early in November, the Task Force held 145 hours of meetings on 20 separate days. In an addition to an organizational meeting on November 7, 1983, the Task Force met on Tuesday, November 15, through Thursday, November 17, 1983, inclusive; Tuesday, November 29, through Thursday, December 1, inclusive; Tuesday, December 6, and Wednesday, December 7; Tuesday, January 10, through Thursday, January 12, 1984, inclusive; Tuesday, January 31, through Thursday, February 2, inclusive; Tuesday, February 14, and Wednesday, February 15; and Tuesday, March 20, through Thursday, March 22, inclusive.

Roughly, the first one-half of these meetings was devoted to receiving the views of interested parties not represented on the Working Group. In a series of open and closed hearings, forty-seven separate individuals or groups presented testimony to the Task Force. The witnesses included the Government of Japan, the Internal Revenue Service, the United Kingdom's Board of Inland Revenue, the General Accounting Office, the U.S. Treasury Office of International Tax Counsel and Office of Tax Analysis, the Congressional Joint Committee on Taxation, state tax administrators, eight U.S. business firms, eight foreign-based business firms, seven business or trade associations, including three with predominantly foreign membership, three labor organizations, three public interest groups, two small business associations, several attorneys and accountants, and a specialist on constitutional aspects of federalism. In addition, at least thirty highly-informative written statements were received from a diverse group of private witnesses not choosing to appear before the Task Force in a personal capacity. The Task Force also received written statements from the Governments of Australia, Belgium, Canada, the Federal Republic of Germany, the Netherlands, Switzerland, the United Kingdom, the ten-member European Community, and from the European Commission. The Task Force spent the other half of its meetings digesting and analyzing the testimony and information it received and in developing the options presented in this report.

. . .

ISSUES

The material presented to the Task Force identified and described the following specific problems perceived to exist with the application of the worldwide unitary and separate accounting methods of taxation.

Perceived problems with worldwide unitary

– Compared to separate accounting, distorts the measurement of taxable income. May result in either over or under taxation.

– Because of income and factor distortion for both U.S. and foreign-based companies, may interfere with international trade and investment flows and harm the competitive position of U.S. industry.

– Because of relatively larger proportion of foreign to U.S. activities, income distortion is generally greater for foreign-based multinationals than for domestic-based groups.

– Departs from the internationally-accepted standard of taxation, which is based on arm's-length or separate accounting principles.

– Has given rise to vigorous foreign objections and retaliatory threats.

– Administratively burdensome, especially for a foreign-based multinational which must report its worldwide income and apportionment factors in U.S. dollars under tax accounting principles used by various states. U.S. subsidiary may not have access to the necessary information relating to the activities of its foreign parent and sister subsidiaries.

– Absence of a consistent and appropriate definition of a unitary business gives rise to an unacceptable degree of taxpayer uncertainty.

Perceived problems with separate accounting

– Compared to worldwide unitary, may distort the measurement of taxable income, resulting in different tax liabilities for individual companies. May result in either over or under-taxation.

– Because of income distortion, may lead to undertaxation of multinationals; may shift the corporate tax burden onto smaller business and put them at a competitive disadvantage.

– Because of the economic interdependence created by shared expenses, economies of scale, and other factors within a multinational, separate accounting may fail, even in theory, to measure income accurately.

– Administratively complex. Given the millions of transactions that must be reviewed to audit on an "arm's-length" basis, may be administratively burdensome for state revenue officials. States lack resources to administer it effectively.

– Provisions protecting confidentiality of tax information in current exchange of information agreements between the U.S. and foreign governments may prevent the federal government from sharing with the states the information received from other countries which would assist in verifying the allocation of income between affiliated firms determined under separate accounting.

– Absence of consistent and appropriate ways to determine "arm's-length" prices may create unacceptable degree of taxpayer uncertainty.

OPTIONS

The Task Force has fulfilled its mandate to develop options for decision by the Working Group. As the Working Group instructed the Task Force, all of the options are based on the assumption that adoption of specific state policies would be voluntary and not mandated by restrictive federal legislation. Option One involves a relatively modest departure from the use of the worldwide unitary method; it would apply solely to foreign-based multinationals. Options Two through Six would limit the unitary method to the water's edge and therefore would involve more significant changes in policy for the twelve states presently using the worldwide unitary method. Options Two through Six also assume the execution by the federal government of specific actions to encourage greater disclosure of domestic income, increased compliance with state tax laws, and improved enforcement of the arm's length standard.

While Options Two through Six contain many common elements, they differ in several areas, most notably in the proper tax treatment of dividends received from foreign subsidiaries. Many Task Force members believe that the foreign dividends issue is critical and that its resolution must be part of any solution to the problems at hand. Those members, in other words, believe that it would not be acceptable to seize solely on the common elements in Options Two through Six as the solution to the "unitary problem," but leave the foreign dividends issue unresolved.

OPTION ONE: ACTIVITIES TAX IN LIEU OF UNITARY APPORTIONMENT SOLELY FOR FOREIGN-BASED UNITARY GROUPS

Description

A corporation which is part of a unitary business and whose parent corporation is neither organized nor conducts business in the United States would be allowed to pay an alternative tax based on its in-state payroll, property, and sales. The corporation could elect this alternative tax in lieu of being subject to the worldwide unitary method. The rate for the activities tax would be calculated on an industry basis with reference to the tax paid by members of the industry conducting a unitary business within the state.

Proponents' analysis

This option is a response to the concerns that led to the establishment of the Working Group. Specifically, it would offer an alternative to the requirement, opposed by foreign multinationals and foreign governments, that foreign companies use the worldwide unitary method. At the same time, by requiring them to pay a tax on their in-state activities in lieu of an income tax measured by the worldwide unitary method, this option would protect the competitive position of U.S.-based multinationals and smaller businesses as well as the revenue bases of the states. To the extent that foreign governments object to the worldwide unitary method itself, rather than to the actual level of state taxation, this option should end threats of retaliation. For those states now using the worldwide unitary method, this option, compared to Options Two through Six, would require the smallest change from their current practice and should be least burdensome for state revenue officials and taxpayers. It would involve minimal loss of revenue and administrative burdens on foreign-based multinationals.

Opponents' analysis

Foreign governments may find the alternative activities tax just as objectionable as the worldwide unitary method. Since the level of the activities tax would be set on an industry basis, some foreign-based multinationals would have increased state tax liabilities, while others would have reduced liabilities. The former would not elect the alternative tax and would still object to the worldwide unitary method; the latter would not be satisfied by being required to pay an activities tax in excess of what they might otherwise be paying on a separate accounting or arm's length basis. Thus, foreign government officials could still assert that the activities tax gave rise to extraterritorial taxation and that it was a departure from the international arm's-length standard. This option would not correct the problems U.S. business associates with the worldwide unitary method. Depending on the circumstances of individual firms, some U.S.-based businesses could be required to pay higher taxes than their foreign counterparts, even when profit rates were equivalent. Thus, this option could place individual U.S. firms at a competitive disadvantage by tilting what should be a "level playing field" in favor of foreign competition. It therefore conflicts with the Working Group's directive to the Task Force to treat U.S. and foreign business in a non-discriminatory manner. For the same reasons, this option might be subject to a constitutional challenge on due process and equal protection grounds.

COMMON ELEMENTS OF WATER'S EDGE / OPTIONS TWO–SIX

Options Two through Six each describe ways of limiting the worldwide unitary method to the "water's edge." In other words, the unitary method, under each of these options, would be limited to a specifically defined water's edge group. The following common items, summarized here, are included in Options Two through Six. The text of the footnotes. . . provide interpretation of the general descriptions in this text. . . . In every case the language of the footnotes controls over the more abbreviated wording in this text.

Options Two through Six all involve proposals for increased federal actions to promote disclosure and encourage compliance. The states and the federal government, however, differ on the exact federal proposals. The federal proposals are included in this Common Elements section; the state proposals in the section entitled, "State Proposals for Additional Federal Actions."

A. Components of water's edge combined group

The application of the unitary method would be limited to the following "water's edge" corporations which are part of a unitary business:[1]

1. U.S. corporations included in a consolidated return for federal corporate tax purposes;
2. U.S. possessions corporations;
3. companies incorporated in U.S. possessions or territories;
4. domestic international sales corporations (DISCs) (or foreign sales corporations (FSCs) if applicable);
5. certain tax haven corporations presumed to be part of the unitary business;[2]
6. foreign corporations with at least a threshold level of business activity in the United States;[3] and
7. U.S. corporations not included in (1) and with more than 50% of their stock owned or controlled, directly or indirectly, by another U.S. corporation.

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1. *Relationship of entities.* Water's edge combination would be limited to those corporations which are part of the unitary business as determined pursuant to the decisions of the United States Supreme Court and the state courts plus the Tax Haven Corporations as defined in footnote 2 below.
2. *Certain tax haven corporations.* A tax haven shall be defined as any country which either does not impose an income tax or the income tax rate of which is less than some percentage of the U.S. tax rate. A corporation with activities in or incorporated in a tax haven shall be treated as being within the water's edge if: (1) 50% or more of either its sales, purchases, income, or expenses, exclusive of payments for intangible property, or 80% of all expenses, are made directly or indirectly to one or more members of a water's edge group; or (2) the corporation performs no significant economic activity, e.g. the assignment of income under a contract to a corporation which does not perform any services under the contract. It shall be presumed that such a corporation is part of the combinable unitary group; this presumption may be overcome only by a showing that no significant business or economic interdependence exists or that common ownership does not exist.
3. *Foreign corporations* with the lower of either more than 20% of their average payroll, property, and sales or \$10 million of payroll and/or property and/or sales and/or purchases assignable to a location in the United States pursuant to the law of the taxing state.

B. State legal and procedural requirements

In order to ensure full disclosure and maximum accountability, while at the same time limiting compliance costs, "qualified"[4] states would enact the following procedures and remedies:

1. require a taxpayer with unitary foreign affiliates to consent to the taking of depositions and the acceptance of subpoenas for the purpose of obtaining information necessary for determining or verifying its taxable income.[5]
2. establish a presumption that a corporation is part of a unitary business if it does not comply with disclosure requirements or reasonable requests for audit-related information;[6]
3. require a taxpayer to sustain the burden of proof in refuting a state's contention that a unitary business exists within the water's edge combination defined in (A);[7]
4. permit a state, as part of a judicial proceeding, to introduce into evidence the record of any final court determination in another state involving the same taxpayer or unitary business;[8]
5. enact provisions similar to Sections 982 and 6038 of the Internal Revenue Code (Code), which provide penalties and sanctions for failing to provide information;[9]
6. Allow relevant tax information to be introduced into evidence without its relevance being contested;[10]
7. permit the worldwide unitary method to be applied to a taxpayer failing to comply with reasonable discovery efforts aimed at obtaining information necessary to determine or verify its taxable ioncome.[11]

C. Use of worldwide combination

Notwithstanding provision (A) which limits the unitary method to the water's edge, states may use worldwide combination in the following circumstances:

1. if companies fail to comply with either the domestic disclosure spreadsheet filing requirements or the state legal and procedural requirements;
2. if separate accounting, after necessary and appropriate adjustments, fails to prevent the evasion of taxes or clearly reflect income;[12] or
3. if a taxpayer does not provide relevant information on the operations of a foreign-based parent within a reasonable period of time or if the government of that foreign country does not allow the states access to such information.[13]

D. Domestic disclosure spreadsheet

The federal government would:

1. enact a federal law requiring a taxpayer to file information disclosing its tax liability, and the method of calculation, to each state in which it operates. The failure to file this information would be subject to the federal penalties contained in Section 6038 of the Code;[14]
2. require the information described in (1) to be filed on a domestic disclosure spreadsheet. . . by or on behalf of any corporation required to file a U.S. tax return which, with its related corporations, satisfies threshold levels of business activity;[15]
3. require the IRS to receive the spreadsheet described in (2) and review it for completeness;[16]
4. enact legislation to allow the IRS to share with "qualified" states, "common agencies", and a "designated agency" under duly-executed exchange of information agreements information filed pursuant to (a). A "qualified state" is any state that does not use the worldwide unitary method, except as authorized in (C). A "common agency" is any entity designated by and acting on behalf of four or more qualified states to assist in the administration of their tax statutes. A "designated agency" is an agency designated by a plurality of the qualified states that impose a tax on or measured by the net income of corporations;[17]

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4. A "qualified" state is any state that does not use the worldwide unitary method of taxation, except as specifically authorized in section (C).
5. *Consents.* As a condition of being allowed to exclude the income and activities of unitary affiliates which are incorporated in a foreign country and engaged in activities primarily without the U.S., its territories, or possessions, the taxpayer shall file with its state tax return a consent to the taking of depositions from key domestic corporate individuals and the acceptance of subpoenas *duces tecum* with reasonable production of documents within the taxing jurisdiction. This consent is limited to that information necessary to review or adjust income or deductions in a manner authorized under Sections 482 and 861, Subpart F, or similar provisions of the Internal Revenue Code (Code) and the regulations adopted pursuant thereto and an inquiry regarding any unitary businesses in which the taxpayer may be involved.
6. *Presumption.* Failure to include a corporation and its data pursuant to the disclosure requirements of Section (D) or the failure of such corporation to comply with reasonable requests for information necessary to perform an audit in a manner authorized under Sections 482 and 861, Subpart F, or similar provisions of the Code and the regulations adopted pursuant thereto shall create a presumption that such corporation is engaged in a unitary business.
7. *Burden of proof.* The taxpayer has the burden of refuting a qualified state's determination that a water's edge unitary business exists. This requirement shall only apply to an entity within the water's edge combination.
8. *Relevance of results of actions in other states.* A state, at its option, may introduce into evidence the record of any final court determination in another state involving the same taxpayer or unitary business.
9. *TEFRA provisions.* Language similar to Section 6038 of the Code as amended by TEFRA would be enacted providing for fixed-dollar penalties for failure to supply information, pursuant to an administrative request during an audit, concerning transactions between possible members of a unitary group and a foreign corporation more than 50% of the stock of which is owned or controlled by the potential unitary business.
Language similar to Section 982 of the Code would be enacted providing that failure to supply requested documentation or information pursuant to a formal document request may give rise to a court order excluding the subsequent introduction of such material by the taxpayer.
10. *Asmissibility.* Tax information pertaining to the examination of multinational operations, including underlying data, obtained from the Internal Revenue Service or a foreign government would be admissible into evidence without being contested as to relevancy.
11. *Discovery.* The use of the unitary method on a worldwide basis would be specifically retained as a remedy against corporate taxpayers who fail to comply fully with all reasonable discovery efforts directed to the obtaining or ascertaining information necessary to adjust income or deductions in a manner authorized under Sections 482 and 861, Subpart F, or similar provisions of the Code and the regulations adopted pursuant thereto.
12. When a state shows that separate accounting under an arm's-length standard, after the reasonable adjustment of transfer prices and royalty rates and the allocation of common expenses and similar items, fails to prevent the evasion of taxes or does not clearly reflect income.
13. The government of a foreign parent, through a treaty, does not allow the qualified states access to all information obtained by the IRS pursuant to a tax treaty, or, except for military or defense secrets, its national or local law prohibits the IRS or the states access to relevant tax information, which is not otherwise provided by the taxpayer within a reasonable period of time.
14. *Federal filing.* A federal law would be enacted which requires the filing, in appropriate circumstances, of such information as is prescribed by regulations in order to disclose fully the tax liability, and the method of its calculation, reported to each state. The failure to file this information will be subject to federal penalties contained in section 6038 of the Code applicable to controlled foreign corporations.
15. *Filing requirements.* This information would be provided on a domestic disclosure spreadsheet. . . and would be filed by or on behalf of any corporation required to file a U.S. tax return which, together with its related corporations, either has (i) in excess of $1 million of payroll, property, or sales in a foreign country or (ii) has at least $250 million in assets. (Either threshold may be increased by regulations.) Two corporations are related if more than 50% of the voting stock of one company is directly or indirectly owned or controlled by the other or if more than 50% of the voting stock of both is directly or indirectly owned or controlled by the same interest.
The following items of information would be filed with the domestic disclosure spreadsheet, to the extent not otherwise filed with the federal return.
a. A list of the corporate parent and the affiliates of which more than 20% of the voting stock is directly or indirectly owned or controlled by the parent, their FEIN numbers if available, the country in which each corporation is incorporated, and the percentage of ownership. "Affiliates" is meant to include all of a parent company's direct or indirect subsidiaries. With regard to foreign countries, only the foreign subsidiaries directly or indirectly owned by the U.S. corporation would be included.
b. Page 1 (or Schedule A of the consolidated federal corporate income tax return) and Schedule L of federal form 1120 (income statements and balance sheets) of all corporations whose income is included in the income base of a reportable state.
16. *Receipt and review.* The spreadsheet would be received and reviewed for completeness by the IRS. Completeness means that the proper supporting statements and attachments are included. The accuracy of any information on the spreadsheet would be determined by state tax officials and subject to state tax penalties only in the case of significant error. Accuracy means that the information reported on the state tax returns is the same as on the spreadsheet and supporting statement.
17. *Access to information.* All of the information filed pursuant to (1) will be available to qualified states, "common agencies", and "designated agency" through information-sharing agreements with the IRS. A "qualfied state" is any state that does not use the worldwide unitary method of taxation except as specifically authorized in Section (C). A "common agency" shall mean an entity designated by and acting on behalf of four or more qualified states to assist in the administration of their tax statutes. A "designated agency" shall mean an agency designated by a plurality of qualified states which impose a tax on or measured by the net income of corporations. (The qualified states through their tax administrators/governors shall prescribe rules for determining the "designated agency".) Neither a common nor designated

5. request an appropriation to provide funding to an agency for the purpose of making audit referrals to the states. The funding would be limited to a five-year period and would be conditional upon a determination by the Secretary of the Treasury that the policy of no state is inconsistent with the recommendations of the Working Group; and
6. require the IRS to develop and propose regulations necessary to implement the domestic disclosure spreadsheet described in (2).[18]

E. Taxpayer information

A taxpayer would retain the following information for possible use by state tax auditors:

1. specific documents needed to audit issues pertaining to international income flows;[19]
2. the identity of key employees who have knowledge of an access to company pricing and costing policies;[20]
3. documents and correspondence pertaining to the sourcing of income between U.S. and foreign jurisdictions and the determination of foreign tax liability;[21]
4. a listing of the geographic location of payroll, property, and sales for each company listed in the disclosure spreadsheet described in (D)(2);[22]
5. U.S. Tax Forms 5471, 5472, and 5473 filed with the IRS;
6. the type of information requested in the forms described in (5), insofar as it applies to related U.S. corporations;[23]
7. all state corporate tax returns filed by each corporation in each state.

F. Exchange of information

The federal government would:

1. take such steps as are necessary to make information received from other countries available to qualified states and common agencies of those qualified states;
2. enact federal legislation to permit common agencies to enter information-sharing arrangements with the IRS, including the information obtained from a consenting treaty partner;[24] and
3. provide the qualified states and common agencies access to all information developed by the IRS in examining multinational operations and obtained from a consenting treaty partner.[25]

G. Federal assistance

The federal government would:

1. assist qualified states and common agencies in their examination of foreign transactions by establishing a formal communications system between the IRS and the states enabling qualified states or a common agency to request the IRS to examine a taxpayer's income tax return for potential federal issues with ramifications for states;[26]
2. provide IRS training for state tax instructors in international issues; and
3. direct the IRS to provide assistance to states or groups of states in conducting pricing studies of mutual interest to the states and the IRS.

H. IRS audit activity

The federal government would increase its resources devoted to international enforcement issues. Within three years, the IRS would increase over FY 1984 its number of international examiners by 150 (50 per year). This resource increase would be assigned to the enforcement of Sections 482 and 861, Subpart F, and related Code provisions.

I. Joint study

The Treasury, Internal Revenue Service, and qualified states would conduct a study of the Section 482 regulations to make them better instruments for determining tax avoidance and evasion. The study should include the circumstances under which use of apportionment formulas or arm's-length prices are more appropriate.

STATE PROPOSALS FOR ADDITIONAL FEDERAL ACTIONS

Description

The state members of the Task Force propose the following additional federal actions to encourage disclosure and compliance. These proposals, for either cost or policy reasons, are not acceptable to the Treasury department. (The headings refer to the Common Elements of Water's Edge Options Two through Six discussed above.)

D. Domestic disclosure spreadsheet

5. *Audit referral* – Require the Treasury Department to provide a maximum of $10 million annually for audit referrals and not limit the funds to a five-year period or condition them on a finding by the Secretary of the Treasury that no state's policy is inconsistent with the Working Group recommendations.[27]

G. Federal assistance

1. *State-requested federal audits* – Instead of IRS considering state requests to examine returns for federal tax issues, IRS would be required to conduct examinations of international transactions at the request of states using the water's edge approach.[28]

2. *Federal training of state auditors* – Instead of IRS training state tax instructors in international issues, IRS would be required to train state tax audit personnel.[29]

H. IRS audit activity

Instead of a 50% increase in international examiners, IRS would be required to triple the number of international examiners and to

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agency will qualify for access to information unless it has signed a non-disclosure agreement with the IRS as to any non-qualified state.

18. *Regulations:* Proposed regulations to implement this spreadsheet report shall be developed by the IRS. These regulations would include a *de minimis* rule concerning domestic corporations subject to the filing requirements of Section (D)(2).
19. Specific documents and information which are necessary to audit issues involving U.S. versus foreign attribution of income (e.g. Section 482, Subpart F, and Sections 861, 863, 902, and 904 of the Code) shall be retained. This is intended to include any questionnaires developed by the IRS, qualified states, and/or any common agencies.
20. The identity of a few key officers or employees who have substantial knowledge of and access to documents and records that discuss pricing policies, profit centers, cost centers, and the methods of allocating income and expense among these centers. This would include the employer(s), title, and address of each person.
21. All documents and correspondence ordinarily available to a corporation included in the water's edge combination submitted to or obtained from the IRS, foreign countries, and competent authority pertaining to ruling requests, rulings, settlement resolutions, and competing claims involving jurisdictional assignment and sourcing of income that impact the U.S. income. This includes all ruling requests and rulings on reorganizations involving foreign incorporation of branches or changing a corporation's jurisdictional incorporation. It also includes all documents which pertain to the determination of foreign tax liability, including examination reports issued by foreign taxing administrations that are ordinarily available to a corporation included in the water's edge combination. This will not require translation in all cases.
22. List for each company listed in the disclosure spreadsheet, each American state or foreign country in which it has payroll, property, or sales. The sales shall be determined by destination without regard to taxability.
23. The same information requested in U.S. Forms 5471, 5472, and 5473 insofar as the information relates to U.S. corporations of which 50% or more of the voting stock is directly or indirectly owned or controlled.
24. Federal legislation would be enacted which permits common agencies to enter into information-sharing agreements with the IRS. Information-sharing agreements would make information provided under the treaties available to qualified states and their common agents. Also, these agreements would permit the qualified states and any common agencies which have signed substantially similar agreements to share among themselves any information provided to any one of them under such agreements.
25. Federal law or regulations would be amended as necessary to provide the qualified states and any common agencies access to all material developed by the Internal Revenue Service in its examination of multinational operations, or developed through requests under the exchange of information provisions of treaties. This disclosure extends not only to results but to the underlying data as well, regardless of whether an adjustment is made. It also includes all documents relating to the determination of foreign tax liability, including examination reports issued by foreign taxing administrations. It does not, however, contemplate state participation in the simultaneous or industry-wide audit programs of the IRS.
26. A communication system would be established between IRS and the states whereby a state or common agency may request that the IRS examine an income tax return for potential federal issues with state ramifications. After evaluating the request and supporting information, the IRS would make the final determination as to whether an examination is warranted.
27. The state proposal reads as follows: Require the Treasury to provide annual funding, not to exceed $10 million, for the purpose of having the designated agency make audit referrals to qualified states and any common agencies.
28. The state proposal reads as follows: Specific authorization would be provided for the federal government to assist the qualified states and any common agencies in their examination of foreign transactions, including the performance of Section 482 audits upon request by a qualified state pursuant to conditions set forth in regulations.
29. The state proposal reads as follows: The IRS shall conduct training programs for state tax personnel for examinations involving Sections 482, 861, and related provisions of the Code.

report regularly to the states on the Service's enforcement efforts.[30]

FOREIGN DIVIDENDS ISSUE IN OPTIONS TWO THROUGH SIX

The most significant difference between Options Two and Three (State), Options Four and Five (Business), and Option Six (Advisory Commission on Intergovernmental Relations) is the treatment of dividends received by a U.S. corporation from a foreign subsidiary. Under the worldwide unitary method, dividends paid by one corporation to another within the unitary business group are eliminated as intercorporate transactions. That is, the income earned by each corporation is combined with that of its affiliates to determine the taxable income of the unitary group, but intercorporate dividends are ignored.

Under separate accounting, in contrast, intercorporate dividends are recognized explicitly as a flow of income from the dividend-paying corporation to the dividend-receiving corporation. A water's edge limitation on the unitary method (as defined in (A)) would respect the separate entity status of related domestic and foreign corporations, even if they are part of a unitary business. Adoption of a water's edge limitation therefore gives rise to the following issue: how should dividends received by a U.S. corporation from a foreign corporation be treated for state tax purposes?

As mentioned above, the Task Force has been unable to agree on the foreign dividends issue and is referring Options Two through Six to the Working Group for consideration and decision. Many members of the Task Force believe that an acceptable resolution of the foreign dividends issue is an essential precondition of the adoption by the Working Group of the common elements of Options Two through Six described above in sections (A) through (I). Generally speaking, Options Two and Three (State) would include foreign dividends in the state tax base and Options Four and Five (Business) would exempt most or all of the dividends from state taxation. In contrast to the other options, Option Six does not prescribe a specific tax treatment of foreign dividends. Rather, it suggests a principle of non-discrimination; foreign dividends would be treated the same as domestic dividends.

The following discussion summarizes the respective views of the state and business members of the Task force.

State position

The state representatives on the Task Force believe dividends paid to U.S. multinationals by their foreign subsidiaries should be taxable because:

1. Dividends paid by foreign corporations to any other state taxpayer, whether individual or unaffiliated business, are potentially subject to state income tax. Exempting foreign dividends from state taxation when they are paid to a U.S. parent corporation, but not when they are paid to other taxpayers, would be unfair discrimination.

2. National level income taxation is concurrent with, not duplicative of, state level income taxation. Thus, the U.S. government and state governments both tax the same incomes of individuals and businesses. The fact that the income from which foreign dividends are paid may have been taxed by a foreign national government is not multiple taxation and is no reason to exempt it from state taxation.

3. Taxation of foreign dividends is an established and recognized tax policy. About two-thirds of the states include at least some foreign dividends in the tax base of the recipient U.S. parent corporation. Thus, the principle of taxing these dividends is the norm in state taxation, their exemption would have a wide-ranging effect.

4. Foreign dividends are an integral part of the water's edge income of U.S.-based multinational corporations. The federal government recognizes this fact by including them in the U.S. tax base for all taxpayers. Expenses incurred by the U.S. parent company for capital, management, research and development, and the like generate income from foreign subsidiaries as well as domestic ones. Since these expenses are deductible for state tax purposes, the foreign dividend income generated by those expenses should be taxable.

5. Dividends, particularly in the foreign context, are often surrogates for interest, royalties, management fees, and reductions of the cost of goods sold. Thus, to accurately measure income and prevent accounting manipulations to avoid taxation, they should be treated the same for tax purposes.

6. Taxing smaller businesses on 100% of their federal income tax bases while exempting a substantial part of the federal tax bases of multinationals would significantly reduce state revenues and increase the share of the corporate tax burden carried by smaller business.

Business position

The business representatives on the Task Force disagree that foreign corporate dividends are a proper subject of state taxation. They believe that these dividends should be exempt from state taxation for the following reasons:

1. Both federal and many state laws distinguish between the situation in which dividends are paid to a corporation (the issue before the Task Force) and the one in which dividends are paid to an individual shareholder. To prevent income that remains in corporate solution from being subject to multiple levels of taxation, both federal and many state laws allow a generous deduction for dividends received by one U.S. corporation from another. Generally speaking, these dividends are only subject to full taxation when they are received by the individual investor. This policy is followed because the operating income out of which the dividends are paid already is subject to federal and state tax when earned by the dividend-paying corporation. In contrast, subjecting foreign dividends to state taxation when received by a U.S. corporation would result in multiple taxation of income that remains in corporate form. The income out of which the dividends are paid has been taxed in the foreign jurisdiction and the dividends usually have borne a withholding tax levied at source by the foreign jurisdiction.

2. It is misleading to assert that foreign dividends are part of the federal tax base for all taxpayers. While foreign dividend income is included in a U.S. corporation's taxable income, federal law allows a credit against U.S. tax for foreign taxes imposed on both the dividends and the underlying corporate income out of which dividends are paid. Frequently, dividends paid by a foreign corporation bear a foreign tax in excess of the combined federal and state rates in the United States. In this case, to avoid double taxation, no federal income tax is imposed on the foreign dividend income. An unreasonable tax burden results if the states impose tax on these foreign dividends.

3. Unlike the federal system of taxation, which is based on residence or place of incorporation, state corporate tax laws are source based; their objective is to tax income earned in or attributable to a state. Dividends paid by a foreign corporation having no business presence in the states and out of income earned in a foreign country should be beyond the pale of a tax system designed to a tax in-state income.

4. Taxation of foreign corporate dividends discriminates against and interferes with the flow of investment across national boundaries and places U.S.-based business at a competitive disadvantage in the international economy.

5. Foreign dividends should not be subject to state taxation as a way of adjusting for perceived income shifting to low tax jurisdictions. Any perceived profit shifting should be attacked directly, as at the federal level, through enforcement tools such as Sections 482 and 861, and Subpart F of the Code.

6. Foreign dividends should not be subject to taxation merely to raise revenue or to offset perceived revenue losses from not taxing foreign income under the worldwide unitary method. Responding to state revenue concerns, the business members of the Task Force have indicated the willingness of the business community to develop alternative non-dividend revenue sources from business income.

Because it was unable to resolve the foreign dividends issue, the Task Force is presenting the Working Group with five options. Two of the proposals are offered by the state representatives on the Task Force and two by the business members; the fifth option is proposed by the representative of the Advisory Commission on Intergovernmental Relations (ACIR).

30. The state proposal reads as follows: Within four years, the IRS would increase by $72 million over the base for FY 1984 its resources devoted to enforcement of Sections 482, 861, Subpart F, and related provisions. Over the FY 1984 base, 700 international examiners, 652 revenue agents, and 426 additional personnel would be hired. The IRS would report to the states on a regular basis on its compliance and enforcement programs.

OPTION TWO (STATE): COMPREHENSIVE WATER'S EDGE COMBINATION WITH TAXATION OF CASH OR AFTER-TAX FOREIGN DIVIDENDS WITHOUT FACTOR RELIEF

Description

Includes all Common Elements plus these Additional Elements:

1. *Prospective:* This option is intended to operate prospectively upon adoption by each state;

2. *80/20 Corporations:* Any U.S. corporation may be treated as being within the water's edge, regardless of the "source" of its income or the location of its business activities;

3. *Tax havens:* A tax haven would be defined as any country which either does not impose an income tax or whose income tax rate is less than 90% of the U.S. tax rate;

4. *Use of worldwide combination:* If, in the future, the United States Supreme Court or the highest court of any state rules that there is a state or federal constitutional right for a group of corporations to use the worldwide unitary method or any method which reaches a similar result, then the state or states may require the use of the worldwide unitary method;

5. *De minimus jurisdictional standard:* Public Law 86-272 would be amended to provide that any corporation which has sales assignable to a state, under the law of that state, in excess of $500,000 per year for the preceding two years shall not be protected by that law.

6. *Federal actions:* The additional federal initiatives proposed by the states.

7. *Dividends:* All "functionally related" cash foreign dividends would be subject to allocation and apportionment for state tax purposes.

Functionally related cash or foreign dividends after foreign tax would be included in the states' apportionment base without adjustment to the apportionment formula for any portion of the factors of the dividend-paying corporation.

Functionally related foreign dividends are presumed to be those which are:

a) received from a foreign subsidiary of which the voting stock is more than 50% owned by members of the unitary group and which engages in the same general line of business;
b) received from any foreign corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. Significant means an amount of 15% or more; and
c) from the investment of working capital or some other purpose in furtherance of the unitary business.

Proponents' analysis

By limiting the unitary method to the water's edge, this option responds to the complaints of foreign governments and foreign multinationals and protects the competitive position of U.S. multinationals. The state tax base under this option might be slightly smaller than other worldwide unitary combination; if so, it would shift a modest amount of the corporate tax burden to other taxpayers. However, because it includes a comprehensive water's edge combination, full taxation of after-tax dividends, and improved federal compliance efforts and cooperation with the states, this option minimizes the tax shift and revenue loss compared to the Business options (Four and Five). The inclusion of U.S. corporations with over 80% of their business abroad ("80/20" subsidiaries) in the water's edge combination is critical to this result because IRS does not audit transactions between "80/20" subsidiaries and other U.S. affiliates as fully as it examines transactions with foreign coporations.

Opponents' analysis

This option would place U.S. business at a competitive disadvantage in the world economy. By fully taxing cash dividends, it would, compared to worldwide unitary, increase the tax liabilities for many U.S.-based multinationals. Even for those U.S. corporations whose tax liabilities were comparable to worldwide unitary under this option, competitive harm would result because their foreign-based counterparts would be taxable solely on their U.S. operations. Although they are U.S. corporations, "80/20s" should be outside the water's edge since they are essentially foreign, having more than 80 percent of their activities outside the United States. Federal law recognizes this by treating "80/20" dividends as having a foreign source. Precisely because of this, and their eligibility for a foreign tax credit, transactions between 80/20 corporations and other U.S. corporations already receive close scrutiny from the IRS. This scrutiny can be expected to increase under the full accountability and federal compliance measures that are part of this option.

OPTION THREE (STATE): COMPREHENSIVE WATER'S EDGE COMBINATION WITH TAXATION OF "GROSSED-UP" OR PRE-TAX FOREIGN DIVIDENDS WITH FACTOR RELIEF

Description

Includes all Common Elements and all Additional Elements in Option Two (#1 - #7) except #7 which is replaced by:

Dividends: All functionally related foreign dividends would be subject to allocation and apportionment for state tax purposes. "Functionally related pre-tax dividends", including any foreign tax paid on the dividends, would be apportioned on the basis of the factors of the combined group plus a pro-rata portion of the factors of the dividend paying corporations. The pro-rata portion of each payor's factors to be included in the formula would be determined by multiplying the factors of the dividend-paying corporation by a fraction, the numerator of which would be the dividends, including any "gross-up" or foreign tax, paid to the group for the tax year and the denominator of which would be the pre-tax income of the dividend paying corporation for that year, provided that the resulting fraction does not exceed the percentage of ownership of the stock of the paying corporation by the payee corporation.

Functionally related dividends are presumed to be those which are:

a) received from a foreign subsidiary of which the voting stock is more than 50% owned by members of the unitary group and which engages the same general line of business;
b) received from any foreign corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. Significant means an amount of 15% or more; and
c) from the investment of working capital or some other purpose in furtherance of the unitary business.

Proponents' analysis

This option is identical to Option Two except that, instead of taxing after-tax dividends in full, Option Three would tax only a portion of pre-tax ("grossed-up") foreign dividends. While the two options would have different effects on particular U.S. multinationals, the aggregate effect on state tax bases and on the relative share of the tax burden carried by smaller businesses probably would be substantially similar. Option Three responds to the desires of some U.S. multinationals for "factor relief" for dividends. The preferential treatment this would give multinationals would be balanced by the inclusion of dividends before foreign tax, rather than "after" foreign tax. Since factor adjustment looks behind the dividend to the underlying economic activity, the income subject to factor adjustment should be the underlying ("pre-tax") income. This option would require audit techniques substantially similar to worldwide unitary to measure and verify the factor adjustments. Thus, compared to Option Two, this option requires significant additional complexity for state revenue officials and taxpayers.

Opponents' analysis

Like Option Two, this option would, compared to worldwide unitary, place U.S. business at a competitive disadvantage in the international economy. By subjecting grossed-up or pre-tax foreign dividends to taxation, U.S. corporations would be subject to state tax on "income" they can never receive, that is, income earned by a foreign corporation, but paid as taxes to a foreign government, would be included in the states' tax base. Since the foreign dividend would be apportioned on a pre-tax basis, taxpayers with operations in high-tax foreign countries may be subject to tax on an amount exceeding 100 percent of their cash dividend income. The "factor relief" offered by this option is illusory since some taxpayers would face higher tax liabilities than under worldwide unitary. As in Option Two, even those with tax liabilities comparable to worldwide unitary would be at a disadvantage in competing with foreign firms taxable solely on their U.S. operations.

OPTION FOUR (BUSINESS): MODIFIED WATER'S EDGE COMBINATION WITH EXCLUSION OF FOREIGN DIVIDENDS

Description

Includes all Common Elements plus these Additional Elements.

1. *Retroactivity:* The Working Group would, at the very least, include a recommendation for a settlement of retroactive claims under the option;

2. *80/20 Corporations:* Any U.S. corporation with more than 80 percent of its business activities (payroll and property) outside the United States would be excluded from the water's edge combined group;

3. *Tax havens:* A tax haven would be defined as any country which either does not impose an income tax or whose income tax rate is less than 65% of the U.S. tax rate;

4. *Dividends:* Dividends from a corporation at least 80% of whose shares are owned by the taxpayer would be exempt from state taxation while 15% of dividends from corporations less than 80% owned by the taxpayer would be included in the states' tax base.

Proponents' analysis

This option would protect the competitive position of U.S. business by treating U.S.- and foreign-based business in a similar manner; each would be subject to state taxation on their U.S. operations. Like federal law, it recognizes that U.S. corporations with more than 80% of their activities outside the United States are similar to a foreign corporation and should be outside the water's edge. The dividends exclusion would treat domestic and foreign dividends uniformly and in a manner comparable to federal law. This option also would treat intercorporate dividends in a manner similar to the recently passed Illinois law. The exclusion for foreign dividends insures that income that has already borne foreign income tax will not be subject to duplicative taxation at the State level. The retroactivity provision should appeal both to taxpayers and tax administrators as offering a voluntary recommendation for settling the backlog of unresolved tax claims.

Opponents' analysis

By exempting foreign dividends and excluding U.S. corporations such as "80/20s" from the water's edge combination, this option would substantially shift the relative corporate tax burden to smaller business and, compared to worldwide unitary, substantially reduced state revenue bases. In particular, the exclusion of "80/20" subsidiaries will create a significant "tax planning" opportunity to place income beyond the water's edge because the IRS does not audit the transfer prices between "80/20s" and the other U.S. affiliates. Failure to support the increased federal efforts requested by the states would leave the states without the necessary aid to make water's edge combination work. Promoting retroactive application of its provisions would increase several-fold the state revenue losses and the increase in the relative corporate tax burden on smaller business.

OPTION FIVE (BUSINESS): MODIFIED WATER'S EDGE COMBINATION WITH SPECIAL "FOREIGN INCOME" RULE

Description

Includes all Common Elements and all Additional Elements of Option Four (#1 - #4) except #4 which is replaced by:

Special foreign income rule: This option would provide a special rule for income received from foreign affiliates (dividends, interest, royalties, etc.) and for the taxable income of U.S. corporations having more than 80% of their payroll and property outside the United States and its possessions (referred to as 80/20 companies). The taxable income of the combined water's edge group (similar to that determined under line 30 of the federal corporate tax return) would be reduced by a "foreign income component" consisting of dividends, interest, royalties, etc., received from foreign affiliates as well as the net income (or loss) from U.S. corporations having more than 80% of their payroll and property outside the United States. This would establish a threshold or minimum level of "U.S.-source" income to be taxed on an apportioned basis among the states.

Depending on whether the "foreign income component" meets the following tests, it also may enter the states' tax base. First, the "U.S.-source" income, determined above, would be reduced to an after-tax amount by subtracting U.S. federal income taxes deemed paid. Similarly, the "foreign income component" would be reduced to an after-tax amount and combined with its domestic counterpart to determine worldwide income, after tax. This worldwide after-tax income would be apportioned to the United States on the basis of the combined group's U.S. business activity relative to its worldwide activities. The worldwide activities would include the "80/20" companies plus a prorata portion of the activities of the dividend-paying foreign affiliates. If the amount of worldwide after-tax income apportioned to the United States is greater than the after-tax amount of of "U.S.-source" income, the increment would be added to the threshold level of pre-tax "U.S.-source" income to arrive at the income subject to state taxation.

Proponents' analysis

Like Option Three, this option would protect the competitive posture of U.S. business by keeping U.S. corporations with predominantly, or exclusively, foreign operations outside the water's edge and by providing a special rule for income received from foreign affiliates. By treating foreign income on an after-tax basis, it recognizes that income paid in taxes to a foreign government is not a legitimate part of the states' tax base. Still, it recognizes the revenue concerns of the states by including an after-tax foreign income component in the states' tax base.

Opponents' analysis

This option is identical to Option Four except that, instead of excluding "80/20" subsidiaries and foreign dividends directly, the overwhelming amount of this income as well as interest, royalties, and other income received from foreign affiliates, would be exempted by a complex formula. Only in those situations in which after-tax foreign income, as determined under separate accounting, is greater per factor (sales, investment, and payroll) than after-tax domestic income, similarly determined, would this option yield more state revenue than Option Four. This would be the small number of cases in which the complex formula allows states to tax truly foreign income, an obvious case of distortion. Thus, this option may substantially shift the corporate tax burden to smaller businesses and may reduce state tax bases to amounts close to those resulting from Option Four.

OPTION SIX (ACIR): COMPREHENSIVE WATER'S EDGE COMBINATION WITH "NON-DISCRIMINATORY" TREATMENT OF INTERCORPORATE DIVIDENDS

Description

Includes all Common Elements and all Additional Elements in Option Two (#1 - #7) except #7 which is replaced by:

Dividends: Under this option, states would pursue a non-discriminatory policy with respect to the taxation of foreign and domestic dividends. That is, each state would seek parity in the tax treatment of foreign and domestic dividends received by U.S. corporations.

Proponents' analysis

This option would articulate a principle of non-discriminatory state tax treatment of dividends paid by domestic and foreign corporations. States would pursue their own vision of fiscal sovereignty and the current range of diversity in state tax practice would be respected, provided it is exercised in a non-discriminatory manner. Since this option does not compel a single dividend formula, state tax officials would be left free to work with the business community and other taxpayers in developing a rule tailored to the needs, goals, and objectives of the particular state. This option is not likely to be completely satisfactory to those on either side of this issue. It simply sets forth a general principle, but it does not chart a specific way to obtain the goal of parity. Depending on how each state decides to treat intercorporate dividends, this option could have differing effects on state tax bases and revenues, and on taxpayers.

Opponents' analysis

Depending on how the individual states implemented the non-discriminatory policy, this option could adversely affect the competitive position of U.S. industry. Because it does not specify a level of dividend taxation, there is no assurance that a rule similar to the non-discriminatory treatment suggested in Option Four, or adopted by Illinois, will be chosen. Rather, states may respond to revenue concerns by taxing all dividends, foreign and domestic. This would mean higher taxes on U.S.-based multinationals, even compared to worldwide unitary. To the extent that state taxes on all intercorporate dividends, domestic and foreign, were increased, it would result in higher taxes for U.S. business generally, not just those firms with foreign operations. Conversely, to the extent business is successful in having parity legislated at the lower end of the spectrum, state revenues would suffer.

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FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian Pacific Tax & Investment Research Centre, 2 Nassim Road, Singapore 1025, Republic of Singapore.

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

Oracle Business Information, 99c Thetford Road, New Malden, Surrey KT3 5DS, United Kingdom.

U.K. Tax Congress Ltd.: Grosvenor House, 20 London Road, Horsham, West Sussex RH12 1AY. Tel. 0403-56113.

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On Justice in Taxation

By Klaus Tipke

I. INTRODUCTION

In all western parliamentary democracies, people are constantly complaining that the tax laws are unjust and overly complicated. It is difficult to ascertain whether the situation in the non-democratic countries is any better. Politicians are no doubt acquainted with this sad state of affairs; particularly before elections they promise, that once elected, they will make the tax laws of their country more just or "still more just" and less complicated. Such promises have rarely been fulfilled.

In nearly all western democracies, committees of experts have been appointed which, usually after several years' work, have submitted reports comprising several volumes developing criteria for a sound and just tax policy. Alas, the final result has consistently produced merely a few poorly prepared amendments and unskilled, overly hasty implementation. Most experts' reports suggest reducing the number of expenditures, tax privileges and tax exemptions, eliminating loopholes, broadening the tax base and introducing flat rates. Before elections, proposals of this kind are occasionally resurrected and seized upon by politicians but if the latter actually try to implement them after the elections, their realization always founders on the rocks of the opposition parties and lobbies. Overall, in all western democracies, tax law has, without a doubt, over the course of time become increasingly more complex and more and more incomprehensible. In almost every country, the tax authorities are enormously overworked and only partially capable of actually enforcing the tax laws. The tax courts, too, are overburdened and in many countries lawsuits take so long that the situation practically amounts to a denial of justice.

At the same time, the tax laws are a cabala for tax lawyers and accountants. Is a tax reform deserving of the name an "impossible dream" in a democracy?[1] The Nobel prize winner Friedrich von Hayek answered the above question in the affirmative. In his opinion, politicians are interested only in obtaining votes and buy votes by handing out tax privileges without regard to justice.[2] We cannot concern ourselves here with von Hayek's thesis nor with his suggestions concerning a constitutional amendment but, rather, we will respond to the question: what are the requirements for justice in taxation?

In political discussions, the concept of "justice in taxation" is very often used merely as a catchword or as a meaningless formula. Should someone raise the objection that such or such a legal arrangement was surely not just and equitable, he will often be told that the matter had been decided on a political level; or, alternatively, that another solution had not been possible for political reasons. Such a response is a tacit admission that the decision was not based on right but on political might.

Tax laws must not be confused with foreign policy or traffic regulations. Tax law, i.e. the law on the distribution of the fiscal burden, the law, "Recht" (ius, droit, diritto, derecho) – a word that carries with it in German and some other languages the connotation of moral rightness, or "right and just" – must take priority over politics. Hence, tax law policy must always be "a policy of distributive justice".[3]

1. On this see George F. Break/Joseph A. Pechman, *Federal Tax Reform: The Impossible Dream?*, Washington D.C. 1975.
2. Friedrich A. von Hayek, *Law, Legislation and Liberty*, Vol. 1, 3, Chicago and London, 1973.
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Contents

Dr. Klaus Tipke is Professor of Tax Law at the University of Cologne (Köln), West Germany. His best-known publications are his textbook *Steuerrecht* (9th edition, Cologne 1983) and his *Kommentar zur Abgabenordnung* (jointly with H.W. Kruse, 11th edition, Cologne 1983). In 1982 Prof. Tipke published his treatise *Steuergerechtigkeit in Theorie und Praxis* (Justice in Taxation, Theory and Practice). For the first six years after its foundation in 1973, Prof. Tipke was the chairman of the "Deutsche Steuerjuristische Gesellschaft" (German Association for Tax Jurisprudence), a scientific association. He is the editor of *Steuer und Wirtschaft*, a quarterly review subtitled *Zeitschrift für die gesamte Steuerwissenschaft*. - This article (Über Steuergerechtigkeit) was translated from the German by W.E. Weisflog, Brighton, and edited by Patricia Dunn, Bureau legal editor.

II. THE GENERAL CONCEPT OF JUSTICE IN TAXATION

1. Laws based on objective, fair and consistently implemented rules

Just laws, including just tax laws, should only be created on the basis of *objective and fair rules* pertinent to the matter at hand; in other words, rules appropriate to the circumstances that are to be regulated. Such rules are called *sachgerechte Regeln* in German. Moreover, these rules should be consistently implemented.

a. Necessity for rules

The laws must be based on rules (principles or valuations) which set a value standard by which justice can be measured. Irregularity, i.e. an absence of rules, or discretionary action, is arbitrariness, and arbitrariness is the antithesis of justice. If the legislator arbitrarily regulates without underlying rules; if he proceeds at will, in accordance with mere political opportunism, then a basis for justice is missing from the inception.

A tax legislator who follows no rules but merely aims at raising the maximum revenue with the minimum effort is like a highwayman who, in accordance with the expected size of the booty, plunders anyone he pleases. This is so even where the amount of tax payable has been worked out in dollars and cents in the tax schedule. When distributing the tax burden, the ethical premises, expressed in objective and fair rules, must be correct.

b. Necessity for objective and fair rules (sachgerechte Regeln)

The rules which underly a law must, first and foremost, be objective and fair, i.e. rules based on relevant criteria. The legislator must not select just any rules that please him, though, admittedly, the legislator has a certain latitude in making his value judgements.

A law cannot be considered just, simply because it metes out equally to every one the same injustices on the basis of irrelevant or inappropriate rules. Which rules are to be regarded as relevant and appropriate depends on the *purpose* behind the legal provisions that are the basis of the rule. Objective and fair (appropriate) rules state, so to speak, what ought to be taxed, what tax offenses ought to be punished, what merits remuneration and who or what deserves social assistance or subsidies. The result is termed *Sachgerechtigkeit* in German, namely, justice appropriate to the legal subject matter which is to be regulated. As far as taxation is concerned, it has generally been recognized world wide that the ability-to-pay principle is just such a subject matter related rule.

The financial requirements of the State are not such an objective and fair criteria, i.e. not a subject matter related rule. Admittedly, raising revenue for the Exchequer or the Treasury is the primary, or secondary, purpose of taxation. However, this purpose must be achieved by an equitable distribution of the tax burden. Thus, unequal tax burdens cannot be justified by citing the requirements of the public purse. The end does not justify the means, no matter which means, as far as the distribution of the tax burden is concerned. In the interest of the taxpayer and of those required to apply the laws – the tax administrators, the judges and the tax consultants – the legislator should disclose in each case the underlying subject matter related rule. On the legislator rests (morally) the onus of arguing and proving that his laws are appropriate to the circumstances which are to be regulated.

c. Necessity for consistent implementation of the rules

Any inconsistent breaching of the rule or the system results in a departure from consistent ethical valuation and leads to measurement with two or more yardsticks. The subject matter related rule is also the standard of comparison, tertium comparationis, to be used in investigating violations of the precept of equality, so-called "horizontal equity". The legislator must not set aside the consistency of ethical valuation[4] at will, i.e. whenever it may suit him. Inconsistency is an infringement of the idea of justice; in other words, it is against the precept of equality. At any rate, in order to justify any inconsistency, another rule (counter-rule or special rule) must be established which would also serve the public well-being and would not favor certain groups in the society. Admittedly, it is possible that advantages that are granted directly to particular groups may also indirectly benefit the common good and the community at large.

These ideas of justice correspond with Kant's Categorical Imperative "Act according to a maxim that can at the same time be valid as a universal law" and to the so-called Golden Rule "Do not do unto others as you would not wish them to do unto you", or, positively expressed: "Do as you would be done by".

The democratic legislator, too, must keep to these rules of consistency. They are the rules of everyday moral thinking: the fundamental rules of ethical common sense. Moreover, justice also demands that the rule-based law be actually and equally applied (see below, II).

d. No legal order without a system of rules

Only a system of subject matter related, consistent rules leads to a just legal order.[5] There can be no order without rules. Without consistent application of the rules, order is disrupted and confused. In this respect, tax law is no different from traffic law or any other sphere of law. Without traffic regulations, there would be great chaos, many traffic jams and a great number of accidents. Accidents would likewise occur if the road users were given freedom of choice, as is often the case in tax law.[6] Admittedly, overly clever and ill-disciplined drivers might find, even in such disorder, short cuts and detours enabling them to reach their destination first even after having started last. Where rules are lacking, the legislator loses his bearings and the consequences are: a flood of legal provisions without underlying concept, overwhelming problems, problems difficult to overlook, unforseeable problems, disorientation of all those who must apply the laws, etc.

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4. Wertungsmässige Folgerichtigkeit.
5. Rechtsordnung.
6. Wahlrechte: the right to choose between different tax charges (U.S. "tax polarity").

However, tax law must not only be an order (meaning a system) but also a *legal* order;[7] an order based on *law*, meaning a just order. An order (system) becomes a just order if it adopts subject matter related rules, i.e. objective and *fair* rules, *sachgerechte Regeln*. This is, in fact, what distinguishes tax law from traffic law. Road traffic is regulated on the basis of a mere technical order; prescribing either right-hand or left-hand traffic is not a question which involves an ethical valuation. Quite different is tax law; the latter requires objective and fair rules based on relevant criteria, principles or valuations (value judgements). In other words, tax law needs *law* (in the sense of moral rightness) and order. This pair of concepts is not only unpopular with anarchists but one must bear in mind that the opposite of law and order is unlawfulness and disorder; chaos.

e. Other advantages of a system of rules over and above the bringing about of justice

"Systems-thinking",[8] i.e. thinking in terms of systems, being guided in one's thinking by subject matter related, consistent rules has other advantages:

- a systematic treatment of the subject, the use of consistent rules protects the law-makers from the temptation of corruption or graft;
- a systematic treatment of the subject matter makes for consistency and clarity of arrangement. Through its rules, it increases the possibility of finding one's bearings and leads out of confusion. Hence, it increases the security of law and, in particular, is of aid in interpreting the purpose of a statute;
- a systematic treatment eliminates gaps, undermining those who look for legal loopholes and who create tax shelters. No legislator can forsee all possible situations. When legislating he usually has only a few situations in mind. In order to encompass all situations that may arise, the legislator must be able to rely on rules;
- a systematic treatment makes the law and its ethical foundation apparent and intelligible, makes it comprehensible and thus explainable, teachable and learnable. This process of thinking presupposes a systematic structure, a regularity, i.e. a regular, systematic arrangement of the subject matter under review. When these prerequisites are absent, a vast amount of detailed written material must be blindly learned by rote. The contents of a rag-bag of unconnected meaningless legal provisions, a legal hotchpotch, cannot be absorbed by the act of thinking but can only be absorbed by "cramming". Only a system of values allows the transmission of "orientation knowledge"[9]. No one can find his way in a quarry of amorphous details and fragments;
- a systematic treatment relieves the mental strain on, and thus facilitates the work of, taxpayers and tax consultants, revenue officials and the fiscal judiciary. Hence, it results in a less costly administration of taxes and in reduced compliance costs. A system is recognizable by qualified tax officials and tax consultants without the need for innumerable detailed and unconnected administrative directives;
- only by means of systematic legislation will it be possible to decrease the mountain of problems and to bring the mass of unruly problems under control. Only then will the tax courts be relieved of the awesome burden of too much litigation;
- generally, systematic law which is based on clear rules can be implemented more readily than a chaotic, inconsistent law that has numerous loopholes. Admittedly, systematic law can also become overly complicated if too many refinements are added to the system. The systematizers must take into account that tax administration is "wholesale (mass) administration" and that the tax authorities are unable to function without concessions to practicality. Thus, a certain degree of standardization and "lumping together" is necessary. By taking the principle of practicality into consideration, the precept of equality is also indirectly being observed, since laws which are impractical, or even unenforceable, cannot be applied equally and uniformly. If, for instance, it is not possible, for reasons of practicality, to fully implement the ability-to-pay principle vis-à-vis a certain group of taxpayers, then, for the sake of equality of taxation, other groups of taxpayers, who are legally in a similar position and toward whom the provisions in question *could* be put into effect, should not be taxed either;
- last but not least, anyone who thinks that tax systematics is nothing but legal aesthetics or who regards systematics simply as an aesthetic pastime or luxury and believes that systems defects in the tax system are merely beauty spots on the face of the tax law has not understood that "systems-thinking" is part and parcel of justice.

2. Necessity for the distinction between provisions with a fiscal purpose, provisions with a social purpose, and provisions aimed at simplifying tax administration (simplifying provisions)

a. Provisions with a fiscal purpose and basic rules applying thereto

The systematic reform of fiscal law must begin with a taking stock and with a sifting and sorting of the present jumble of tax laws by categorizing them and by applying appropriate rules. Firstly, a distinction has to be made between tax provisions with a fiscal purpose[10] and tax provisions with a social purpose,[11] in the widest sense of the word (see section b below). The objective of fiscal provisions is, of course, to raise money for the Exchequer or the Treasury.

The basic role which ought to underlie any provisions with a fiscal purpose should always be the ability-to-pay principle (taxable capacity principle). It would appear, in this respect, that there is no ethical pluralism of values in the western democracies. The pluralism of divergent conservative, liberal and socialist views is only manifested when the scale of tax rates is being drawn up. To be sure, lip service paid to the basic valuation (i.e. the ability-to-pay principle) on the one hand and its consistent application on the other hand diverge considerably.

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7. Rechtsordnung.
8. Systemdenken.
9. Orientierungswissen.
10. Fiskalzwecknormen; in short, "fiscal" or revenue-raising provisions.
11. Sozialzwecknormen; in short, "social" or regulatory provisions.

The ability-to-pay principle protects the taxpayer, through appropriate tax bases, from State intervention over and above his ability to pay. The principle does not establish a progressive scale of tax rates but establishes bases of assessment (tax bases) which are suitable for measuring the ability to pay. Not only a progressive but also a proportional tax structure corresponds to the ability-to-pay principle. It is only the *social* component of justice that demands a progressive tax schedule. The Welfare State (providing it does not degenerate into a State supporting the antisocial elements in society but only aids those who, through no fault of their own, are unable to support themselves) also relies on a progressive tax schedule. Defense expenditure, too, is another public sector that could not be financed merely with a proportional tax schedule.

In so far as opponents of the ability-to-pay principle favor the benefit (of services) principle of taxation,[12] they do so, as a rule, only in the most general terms. They do not enter into detail or they pass over or refuse to recognize the fact that it is practically impossible to attribute to any particular individual the exact monetary amount of benefits or services provided by the State – such as defense, etc. In the exceptional case where such is feasible, there can be no objection to application of the benefit principle, particularly in those cases where citizens behave in a socially undesirable manner thus making it necessary for the State to intervene, e.g. by having to bring in its police force. Hypothetically, let us take a case where the police have to be called out at a football match. There is no reason why the taxpayers, in general, should have to foot the bill rather than the spectators who, through their misbehavior, provoked such police action.

b. Provisions with a social purpose and basic rules applying thereto

By tax provisions with a social purpose, in the widest sense of the term, we mean interventionist or regulatory provisions which are motivated by considerations of social policy, economic policy, cultural policy, health policy, occupational or professional policy,[13] etc. They consist, as a rule, of tax reliefs but may also consist of tax increases, i.e. special tax charges. In the laws presently in force, they are generally intermingled with the "fiscal" provisions. Technically, the "social" provisions are usually inserted into the various sections of the income tax laws which encompass the assessment bases (tax bases). Tax provisions with a social purpose must not be based on the ability-to-pay principle since that would not be appropriate, nor would it be subject matter related. Rather, other principles of subject matter related justice (Sachgerechtigkeit!) are pertinent, such as the principle of need or the principle of merit. It is not possible to enumerate in this short paper all the relevant principles. If, as a result of the fiscal technique usually applied (deductions or relief from the tax base) and because of the progressive tax schedule, the taxpayers who benefit most are the ones who need, or deserve, it least, then the arrangement is not objective and fair. In those cases where a particular aim is promoted by the State through "open" subsidies, the legislator would hardly dare to favor those with the highest income. Nevertheless, the State does not eschew such undesirable effects when it can hide behind the technique of fiscal law.

c. "Simplifying provisions"[14]

Fiscal law is "wholesale law",[15] i.e. law which has to deal with a large volume of similar cases and, as such, is dependent on provisions aimed at simplifying the administration of taxes, in short "simplifying provisions". These provisions serve the purpose of simplifying the application of fiscal law for reasons of practicality. They aim at avoiding excessive complexity or even impracticability (impossibility of enforcement). However, since the simplifying provisions are merely a technical measure, they do not rank equally with the (ethical) principle of ability-to-pay so far as the ethical hierarchy of values is concerned. Simplifying provisions have to take the average cases as the norm. The advantage of practicality must not result in a disproportionate loss of justice in the individual case.

d. Reasons for separating provisions with a fiscal purpose from those with a social purpose

He who does not differentiate between provisions with a fiscal purpose and provisions with a social purpose and he who mixes everything up without resort to rules has no clear view of the subject matter, whether he be the one who makes or the one who applies the law. A distinction between the two types of provisions is, moreover, necessary for interpreting the purpose of a statute, for uncovering loopholes in the law and for judging violations of the precept of equality.

If provisions with a fiscal purpose and provisions with a social purpose are, wherever possible, separated from each other, then the sections of the tax law which contain provisions of a truly *fiscal* (i.e. revenue-raising) nature become stable and lasting and there will be no necessity to alter them constantly. At the same time, it is easier for the taxpayer to observe the laws. Experience shows that citizens will obey the law to a surprising degree – even without an exact understanding of the law – where permanent laws are involved which have, so to speak, become "institutionalized". The situation is quite different when amendments are churned out like daily newspapers. In so far as provisions of a social nature, again in the widest sense of the term, are concerned (provided they are suitable for achieving the envisaged objective), adapting them dynamically to prevailing economic and social conditions is a necessity.

"Social" provisions that benefit certain groups of taxpayers only are tantamount to privileges if they are not based on an objective and fair, subject matter related and consistent rule which can justify such privileges. From the aspect of the precept of equality, however, privileges are an injustice that must be eliminated.

In many countries the politicians, in trying to outdo each other with promises, have created a kind of "tax relief inflation". As a result, many tax reliefs cannot be justified when examined in the light of the common well-being.

3. Necessity for coordinating tax laws and social security laws

Those who have the ability to pay, pay taxes: those who are in need (negative ability to pay) receive social securi-

12. Aequivalenzprinzip.
13. Berufspolitik (berufspolitisch).
14. Vereinfachungsnormen.
15. Massenfallrecht.

ty benefits (welfare payments). However, in many countries the tax laws and the social security laws are not sufficiently coordinated. In the tax laws, the income tax threshold is often fixed considerably below the subsistence level (the "poverty line") laid down in the social security laws. Very often, the two branches of the law operate with different definitions of income and net worth (wealth). Such differences should be removed. The reliefs and welfare payments must be coordinated.

III. NECESSITY FOR EQUAL AND UNIFORM APPLICATION OF THE TAX LAWS AS A REQUIREMENT FOR JUSTICE IN TAXATION

The effective implementation of the tax laws is not only a matter of securing tax revenue. Much more important than this one-sided fiscal view is the aspect of justice. The philosophy of law states that the observance of a legal rule can only be expected if one can be certain that everyone else will also observe the rule. This certainty exists, however, only if the disobedient citizen can, if necessary, be forced to obey. The fiscal obedience of the individual is based on the belief that the tax burden is being imposed on all fellow citizens in accordance with the same criteria. For this reason the honest taxpayer expects that the State will enforce the tax laws on an equal basis. The rules of law have social validity only insofar as the individual who does not observe them voluntarily must reckon with compulsory enforcement.

As everyone knows, trust is good, verification better. This is particularly true in the case of taxpayers. If trust is substituted for the fiscal audit, first the ill-disciplined and unscrupulous will seize their opportunity, then others will follow. In time, the breach in the legal order is widened and irregularity becomes the rule. Particularly in fiscal law – law which imposes a tax payment without a concrete quid pro quo – there will always be small, or even large, shortfalls in the observance of the law. In fiscal law above all, those responsible for its administration cannot realistically expect that the taxpayer will always obey the provisions of the tax code based on a law-abiding attitude, a sense of duty or an understanding of the interconnections. This is especially true, since many taxpayers have lost faith in the rightfulness of the tax legislator, and believe fiscal law is no longer rational or sensible because it is, at present, not sufficiently built on objective, fair and consistent rules. Hence, even citizens to whom it would never occur to steal from or to cheat their fellow citizens do not lose much sleep over the fact that they are cheating the anonymous community and its members. If the tax legislator does not enforce the tax code by means of checks and sanctions, then the danger is that entire groups of taxpayers will be taxed differently, not as a result of provisions in the tax code, but due to different *observances* of the tax laws, with the result that particular legal provisions, or even whole sections of the tax code, lose their social validity altogether.

Besides, it is quite possible that taxes are not only evaded knowingly and willfully but also from sheer ignorance of the tax laws. If even experts no longer comprehend the complex tax legislation, then the tax code is certainly a sealed book as far as the ordinary layman is concerned! Therefore, as long as fiscal law remains overly complicated, nearly all tax returns completed by laymen without the assistance of an accountant are bound to be more or less incorrect.

IV. TAX LAW AND THE LAW OF TAX OFFENSES CONSIDERED FROM THE STANDPOINT OF JUSTICE

A just law on tax offenses and misdemeanors is not feasible without a just tax law since the law on tax offenses is intertwined with the tax law. The ethical judgement of unworthiness[16] pronounced by the law on tax offenses presupposes a tax law based on ethics. The awareness of illegality, in other words, the awareness of having committed an unlawful act, which the law on tax offenses requires, can only develop from a law that is recognized as just. An attitude of moral *rightness* in tax law, a sense of *right* or wrong, can only develop if it is possible to recognize the ethical foundations or the subject matter related rules underlying the legal provisions in question. A sense of right or wrong in tax matters cannot develop if these legal provisions can be altered by the legislator whenever he thinks fit. According to criminologists, criminal law requires that a person examine his or her conscience in order to remove doubts as to right or wrong. Everyone well acquainted with tax law knows, however, that very often neither ethical ideas, nor notions about value or worth nor intellectual cognitive faculties are able to provide a taxpayer who is in doubt about the right course to pursue, with a clear picture of the legal position.

The success of the State in educating the taxpayer to absolute honesty in tax matters would be considerably greater if:

- the taxpayer could see that the tax law system is not merely a hotchpotch of unsystematic compromises of group (i.e. sectional) interests but is a well-planned order (system) of justice based on objective and fair (sachgerechte!) and consistently implemented rules;
- taxpayers recognized that the politicians' espousal of justice in taxation is not mere lip service;
- taxpayers were not under the impression that there is such waste and misapplication of the revenue by the State. "Tax morality" goes hand in hand with ethical morality as regards the use and application of tax revenues;
- taxpayers were not under the impression that tax evaders go unpunished and that the latter could utilize their own competitive and financial advantages in peace and security, unmolested by tax authorities;
- taxpayers were not under the impression that the State exploits the producers of the wealth, in the widest sense, to the benefit of those unwilling to work, the lazy or the sham needy; that the State perverts the Welfare State into a State of Antisocials; that unworthy persons are being supported by taxpayers' hard earned money and that the State is too strict vis-à-vis tax offenders but too lenient towards abusers of the social security system;
- finally, prominent politicians gave a shining example of "tax morality" rather than ruining tax morals by abuse of the tax laws.

16. Unwerturteil.

INDIA:

Taxation of Foreign Companies

By Har Govind

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The Income-tax Act (hereinafter "I.T. Act") is a self-contained Code as regards the definition of a company and a foreign company. The term "company" is defined in Section 2(17) of the I.T.Act. Here it is sufficient to note briefly that in addition to an Indian company, i.e. a company formed and registered under the *Companies Act*, it also includes (i) any body corporate incorporated by or under the laws of any foreign country and (ii) any institution, association or body whether incorporated or not and whether Indian or non-Indian which is declared by an order of the Central Board of Direct Taxes to be a company. An entity about which there is some doubt of its being a company and which desires to be treated as a company for income tax purposes should approach the Central Board of Direct Taxes to obtain a declaration as a company.

Foreign company defined

As noted earlier, a company incorporated in a foreign country is also a company under the I.T.Act. A foreign company as defined in Section 591 of the *Companies Act* broadly means a company incorporated outside India, which has a place of business in India. However, the concept of a foreign company as defined in Section 80B(4) of the I.T.Act is somewhat different from its meaning under the *Companies Act*, since in this Section it means a company which is not a domestic company. Section 80B(1) of the I.T.Act defines a domestic company as an Indian company or any other company which in respect of its income liable to tax has made under Rule 27 of the I.T.Rules the prescribed arrangements for declaration and payment of dividends in India. These arrangements are:

(i) the share register of the company for all shareholders is maintained in India,
(ii) the general meetings for passing of accounts and declaration of dividends are held in India, and
(iii) the dividends, when declared, are payable in India to all shareholders.

The basic approach in the case of a domestic company is that in addition to its profits, the dividends to all shareholders should also be subject to Indian tax. Thus, a company registered outside India can become a domestic company under the I.T.Act by making the arrangements prescribed in Rule 27. The main picture of a foreign company which emerges from this discussion is that it is a "non-domestic" company.

The term "Indian subsidiary of a foreign company" refers to companies registered in India in which a single foreign company holds more than 50% of the paid-up equity capital. Such subsidiary is not a foreign company. It is an Indian company and is a separate assessable entity from the foreign holding company. As per available statistics, there are more than 500 foreign companies operating in India directly through Indian offices or branches: per country, it is U.K. 301, U.S.A. 81, Germany (Fed. Rep.) 12, Canada 7 and others 109.

Computation of taxable income

Taxable income is computed under six heads, namely, (i) salaries, (ii) interest on securities, (iii) income from property, (iv) income from business or profession, (v) capital gains and (vi) income from other sources such as dividends, royalties and interest on deposits with banks. This is done after allowing deductions for admissible costs and expenses, depreciation and allowances. The income from each of these heads is then aggregated to arrive at the gross total income. Certain deductions are allowed under Chapter VIA of the I.T.Act from the gross total income by way of reliefs and incentives. Two important tax incentives which may be of interest to foreign companies are (i) the special deduction under Section 80HH for a newly established industrial undertaking or hotel business in backward areas and (ii) the deduction under Section 80I for a new industrial undertaking which starts manufacture or production of certain specified high priority articles after 31 March 1981.

Zero tax companies: Sec. 80 VVA

A new restriction has been imposed on certain deductions effective from 1 April 1984 in the case of companies making profits and paying no tax at all, or only a nominal tax. The Finance Minister observed in Paragraph 90 of his 1983 Budget Speech that such companies should contribute at least a small portion of their profits to the national exchequer when less affluent sections of society are bearing a burden. As followup action a new Sec. 80 VVA has been added to the I.T.Act to provide that fiscal incentives and concessions available under certain sections of the I.T.Act specified in the new Sec. 80 VVA shall not absorb more than 70% of the profits. Thus, companies will pay a minimum tax, on at least 30% of their profits. Depreciation whether normal, initial, additional or extra is not hit by this new restriction and shall be deductible in full as before.

Tax is levied on the net income worked out after deducting admissible costs, expenses, concessions and incentives. The net balance is also called the taxable income. The broad pattern of computation of taxable income of foreign companies is more or less similar to domestic companies with some specific differences. For example, tax concessions for newly acquired ships for carrying passengers or goods or a newly established hotel in a non-backward area are available to Indian companies only.

Further, there are specific departures from the general scheme, for the sake of simplicity or to confer some concession, in the case of foreign companies in the following matters:

(i) Source rules for dividends, interest, royalties and technical fees: Sec. 9.
(ii) Deduction of head office expenses: Sec. 44C.
(iii) Computation of income from royalty and technical fees: Sec. 44D.
(iv) Tax on dividends, royalties and technical fees: Sec. 115A.
(v) Rate of tax: Schedule I to Annual Finance Act.
(vi) Foreign oil companies.

The above features which are special for foreign companies will be discussed in greater detail.

Tax liability and residential status

The scope of income liable to tax in India of a company depends on its residential status, that is, whether it was "resident" or non-resident in the previous year, which is the year immediately preceding the tax year (accounting year). A tax or assessment year in India runs from 1 April to 31 March, next. In the case of a resident company its global income is taxable regardless of source. Thus, income earned both in and outside India is liable to tax. A non-resident company pays tax on its Indian-source income only. Its foreign income is exempt. Income which is received in the first instance outside India is not treated as Indian-source income on its subsequent transfer or remittance to India.

According to Sec. 6(3), a company is said to be resident in India in any previous year, (i) if it is an Indian company or (ii) if during that year the control and management of its affairs is situated wholly in India. Even if part of the control and management is situated outside India, the company cannot be treated as resident. A foreign company will therefore be invariably "non-resident" in India.

Foreign collaboration agreements

Foreign collaboration agreements have played and are playing a useful role in the economic development of India. To accelerate industrial development, besides indigenous efforts, foreign investment and foreign technology of a higher order are needed. From 1947 to the 1960s foreign collaboration for finance and technology were liberally permitted by the Government. To avoid too heavy leaning by Indian industry on foreign help for long periods of time and keeping in view the pace of industrialisation in India and the progress of indigenous technology, foreign financial participation has been brought down to 40% and technical collaboration agreements have been subjected to some regulations; namely foreign technology is to be acquired at competitively lower cost and imported technology must be useful to develop Indian technology. Foreign collaboration agreements involve payments to foreign collaborators in the form of dividends, interest, royalties and technical services fees. This article covers the taxation of these payments in the hands of the foreign companies. The question of admissibility of expenditure under these heads in the hands of an Indian company is not easy due to problems arising from the interpretation of law and clauses of the agreements. This question does not affect the foreign companies directly and is therefore not discussed here.

Assessment procedure (Sec. 163)

The formalities for tax compliance in the case of a foreign company are broadly similar to those for an Indian company. An important difference is that a foreign company, being a non-resident, may either be assessed directly or through an agent. An employer or trustee of the foreign company, a person with whom it has a business connection, a person from whom it is in receipt of any income or a person who has acquired any capital asset from it can be treated as its agent under Section 163. For this purpose the tax authority must give an opportunity of being heard to such a person and pass an appointment order after considering his representation. An agent is legally entitled to be reimbursed for the taxes which he pays on behalf of the foreign company and may retain in his own hands any monies of the foreign company to the extent of the estimated tax liability as may be certified by the tax authority.

Source rules (Sec. 9)

An important concept relating to income accruing or arising in India is income which actually accrues or arises and income which is *deemed* to accrue and arise in India. Such deemed income is income which accrues or arises directly or indirectly:

(a) through or from a business connection in India, or
(b) through or from any property in India or any asset or source of income in India, or
(c) through the transfer of a capital asset situated in India, or
(d) from salaries for services rendered in India (Sec. 9(1)(ii)).

There are some exceptions to the above general rules. Those of interest to foreign companies are summarised below:

(i) Where part of the operations of a business are carried out in India, only income reasonably attributed to such operations is deemed to accrue or arise in India;
(ii) To encourage exports Explanation (b) to Section 9(1)(i) clarifies that no income will be deemed to accrue or arise to a non-resident from the operation of purchase of goods in India for export.
(iii) A new Explanation (c) has been inserted by the Finance Act 1983 to Section 9(1)(i) with retroactive effect from 1 April 1962. It clarifies that in the case of a non-resident no income shall be deemed to accrue or arise from activities of collection of news and views in India.
(iv) Another new Explanation (d) has been added to Section 9(1)(i) by the Taxation Laws (Amendment) Act, 1984. It provides that in the case of a non-resident no income shall be deemed to accrue or arise in India to a person through or from operations which are confined to the shooting of any cinematograph film in India, if such non-resident is either an indi-

vidual who is not a citizen of India or a firm which does not have any partner who is a citizen of India or who is resident in India or a company which does not have any shareholder who is a citizen of India or is resident in India. This amendment will take effect retrospectively from 1 April 1982 and will, accordingly, apply in relation to assessment year 1982-83 and subsequent years.

For simplicity's sake and to reduce disputes, there are separate comprehensive source rules for dividends, interest, royalties and technical fees.

Dividends (Sec.9(1)(iv))

Dividends received in respect of shares in an Indian company are liable to tax in the hands of a resident shareholder. Even in the case of a non-resident shareholder like a foreign company they are taxable because they are deemed to accrue or arise in India under Sec. 9(1)(iv). The company declaring the dividend is required to deduct tax at source before payment to the shareholder. The tax rate on dividend income of a foreign company is 25% under Section 115A(1)(i). The same rate applies for deduction of tax at source from the dividends payable by a domestic company to a non-domestic company. The tax deducted at source is deemed to be tax paid by the taxpayer and credit for such tax is given to him at the time of the assessment. If the tax deducted at source is in excess of the tax payable, the taxpayer is entitled to a refund of the excess amount.

Interest (Sec. 9(1)(v))

Under Section 9(1)(i) of the I.T.Act, as it stood prior to its amendment by the Finance Act, 1976, any income accruing or arising "through or from any money lent at interest and brought into India in cash or in kind" was deemed to accrue or arise in India. It was judicially held that to satisfy the test of taxability, the lending of money abroad and the bringing of the same into India should be an integral part of a composite transaction and the bringing of money into India should be with the knowledge of the lender. Thus, interest on monies borrowed abroad and brought into India without the knowledge of the lender was not chargeable to tax in India. Section 9(1) has now been amended to replace this provision by a simple and comprehensive source rule. Under the amended provisions, interest income of the following types will be deemed to accrue or arise in India.

(a) Interest payable by the Central Government or any State Government;
(b) Interest payable by a resident except in the following cases:
   (i) interest payable by a resident in respect of any debt incurred, or any monies borrowed and used, for the purposes of a business or profession carried on by him outside India; and
   (ii) interest payable by a resident in respect of any debt incurred, or any monies borrowed and used, for the purposes of making or earning any income from any source outside India. It may be noted that where monies borrowed by a resident for the purposes of a business or profession carried on by him outside India are actually used for any other purpose, interest payable thereon will be deemed to accrue or arise in India. Similarly, interest payable on monies borrowed by a resident for the purposes of making or earning any income from any source outside India will be deemed to accrue or arise in India if the monies are actually used for any purpose in India.
(c) Interest payable by a non-resident in respect of any debt incurred, or money borrowed and used, for the purposes of a business or profession carried on by him in India.

It may be noted that interest payable by a non-resident in respect of any debt incurred, or monies borrowed and used, for the purposes of making or earning any income from any source, other than a business or profession carried on by him in India, will not be deemed to accrue or arise in India. Thus, if a non-resident "A" borrows monies from a non-resident "B" and invests the same in shares of an Indian company, interest payable by "A" to "B" will not be deemed to accrue or arise in India. Similarly, if a lead bank obtains loans outside India from a consortium of foreign banks and lends the same to an Indian concern, interest paid by the lead bank to the members of the consortium will not attract liability towards income tax in India.

Royalties (Sec. 9(1)(vi)

Before its amendment by the Finance Act, 1976, under the I.T.Act, a non-resident taxpayer was chargeable to tax in India for royalties received or deemed to be received in India or which accrued or arose or were deemed to accrue or arise in India. There was no definition of the term "royalty". There was no clear-cut source rule specifying the circumstances in which royalty income could be regarded as accruing or arising in India. Further, lump sum payments made for the supply of know-how were not chargeable to tax where such know-how was supplied from abroad and the payment therefor was made outside India even though the know-how was used in India, if no part thereof was attributable to any services rendered in India. The new clause (vi) in Section 9(1) clearly specifies the circumstances in which royalty income will be deemed to accrue or arise in India. It also defines the term "royalty". Royalties of the following types will be deemed to accrue or arise in India:

(a) Royalties payable by the Central Government or any State Government;
(b) Royalties payable by a resident, except where the payment is relatable to a business or profession carried on by him outside India or to any other source of his income outside India; and
(c) Royalties payable by a non-resident if the payment is relatable to a business or profession carried on by him in India or to any other source of his income in India.

In view of the above amendment, royalty income consisting of a lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawings or specifications relating to any patent, invention, model, design, secret formula or process or trade mark or similar property will ordinarily become chargeable to tax in India. In order, however, to reassure foreign suppliers of technical know-how who had entered into agreements or had finalised proposals for the receipt of such lump sum royalties with the approval of the Central Government on the understanding that such payment would be exempt from income tax, it has been provided that such lump sum payments received under approved agreements made before 1 April 1976 will not be deemed to accrue or arise in India, and for this purpose, an agreement made on or after 1 April 1976 will be deemed to have been made before that date if the following conditions are fulfilled:

(i) in the case of a taxpayer other than a foreign company, if the agreement is made in accordance with proposals approved by the Central Government before that date;

(ii) in the case of a foreign company, if the condition referred to in (i) above is satisfied, and the foreign company exercises an option by furnishing a declaration in writing to the Income-tax Officer that the agreement may be regarded as having been made before 1 April 1976. The option will have to be exercised before the expiry of the time allowed under Section 139(1) or Section 139(2) (whether fixed originally or on extension) for furnishing the return of income of the assessment year 1977-78 or of the assessment year in which the royalty income first became chargeable to tax, whichever assessment year is later. The option so exercised will be final not only for the assessment year in relation to which it is made but also for every subsequent year.

Taxpayers exercising the above option will be placed on a par with taxpayers deriving royalty income under approved agreements made before 1 April 1976 in all respects. For the purposes of the aforesaid source rule "property" has been defined in Explanation 2 to Sec. 9(1)(vi). The definition is wide enough to cover both industrial royalties as well as copyright royalties. Further, the definition specifically excludes income which would be chargeable to tax under the head "Capital gains" and accordingly such income will be charged to tax as capital gains on a net basis under the relevant provisions of the law.

Technical fees (Sec. 9(1)(vii))

Income by way of "fees for technical services" of the following types will be deemed to accrue or arise in India:

(a) Fees for technical services payable by the Central Government or any State Government;

(b) Fees for technical services payable by a resident, except where the payment is relatable to a business or profession carried on by him outside India or to any other source of his income outside India; and

(c) Fees for technical services payable by a non-resident if the payment is relatable to a business or profession carried on by him in India or to any other source of his income in India.

The expression "fees for technical services" has been defined to mean any consideration (including any lump sum consideration) for the rendering of managerial, technical or consultancy services (including the provision of services of technical staff or other personnel). It, however, does not include fees of the following types, namely:

(i) Any consideration received for any construction, assembly, mining or like project undertaken by the recipient. Such consideration has been excluded from the definition on the ground that such activities virtually amount to carrying on business in India for which considerable expenditure will have to be incurred by a non-resident and accordingly it will not be fair to tax such consideration in the hands of a foreign company on a gross basis or to restrict the expenditure incurred for earning the same to a prescribed percentage of the gross amount as provided in new Section 44D of the I.T.Act. Consideration for any construction, assembly, mining or like project will, therefore, be chargeable to tax on a net basis, that is, after allowing a deduction in respect of costs and expenditure incurred for earning the same and charged to tax at the rates applicable to the ordinary income of the non-resident as specified in the relevant Finance Act.

(ii) Consideration which will be chargeable to tax in the hands of the recipient under the head "salaries".

By a special provision, income by way of fees for technical services which is derived by a foreign company from an Indian concern under an approved agreement made before 1 April 1976 has been excluded from the source rule. For this purpose an agreement made on or after 1 April 1976 will be deemed to be an agreement made before that date, if it is made in accordance with the proposals approved by the Central Government before that date.

The source rules on interest, royalties and fees for technical services have been embodied in the I.T.Act effective from 1 June 1976 and are operative for and from the assessment year 1977-78 and subsequent years.

Head office expenditure (Sec. 44C)

Non-residents carrying on any business or profession in India through a branch are entitled to a deduction, in computing taxable profits, for general administrative expenses incurred by the foreign head offices in so far as such expenses can be related to their business or profession in India. It is extremely difficult to scrutinise and verify claims in respect of such expenses, particularly in the absence of account books of the head office which are kept outside India. With a view to surmounting these difficulties, the Finance Act, 1976 has inserted a new Sec. 44C in the I.T.Act laying down certain ceiling limits. Under this provision, the deduction for the head office expenses will be limited to the smallest of the following three amounts:

(i) an amount equal to 5% of the adjusted total income of the taxpayer for the relevant year; or

(ii) the annual average of the head office expenditure allowed during a base period of three previous years, namely, the previous years to the assessment years 1974-75 through 1976-77; or

(iii) the actual amount of head office expenditure attributable to the business in India.

In cases where the adjusted total income of the non-resident for the current year is a loss, the rate of 5% referred to at (i) above will be applied with reference to the average adjusted total income of the non-resident for the three previous years immediately preceding the relevant year.

The term "head office expenditure", as defined for the purposes of this provision, means executive and general administration expenditure incurred by the non-resident taxpayer outside India, including expenditure for:

(a) rent, rates, taxes, repairs or insurance of any premises outside India used for the purposes of the business or profession;
(b) salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profits in lieu of or in addition to salary, which are paid to any employee or other person employed in, or managing the affairs of, any office outside India;
(c) travelling by any such employee or other person outside India;
(d) such other matters in connection with the executive and general administration as may be prescribed by the Board. To date no rules have been issued. The reason is that perhaps no need has arisen. If foreign companies encounter difficulties, they may approach the Central Board of Direct Taxes to frame appropriate rules.

The expressions "adjusted total income", "average adjusted total income" and "average head office expenditure" have been defined in the Explanation to Section 44C.

Computation of royalty income, technical fees and interest (Secs. 44D & 58)

Prior to 1 June 1976 taxable royalty income was determined on a net basis, that is, after allowing deduction for cost and expenses incurred for earning the income. The Finance Act, 1976 has inserted a new Section 44D and amended Section 58. The provisions of these two sections lay down special rules for computing income by way of royalties and fees for technical services received by foreign companies from Indian concerns. The rules are the same whether such income is treated as income from a business or profession or is assessed under the head "other sources".

Where such income is received under agreements made before 1 April 1976, the deduction for expenses incurred for earning such income will be subject to a ceiling limit of 20% of the gross amount of such income, as reduced by the amount, if any, of so much of the royalty income as consists of a lump sum consideration for the transfer outside India or the imparting of information outside India, in respect of any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property. The aforesaid ceiling limit will be applicable in relation to all royalties or technical service fees received under agreements whether approved by the Central Government or not. For this purpose, an agreement made by a foreign company with an Indian concern on or after 1 April 1976 will be regarded as an agreement made before that date if such agreement is made on the basis of proposals approved by the Central Government before that date and the foreign company has exercised an option in this behalf under Sec. 9(1)(vi).

As regards royalties and technical service fees received under agreements made on or after 1 April 1976 (other than agreements which though made on or after that date are regarded as having been made before that date), no deduction will be allowed in computing the income from the aforesaid sources, regardless of whether the agreement has been approved by the Central Government or not. Such royalties and technical service fees will, if payable under agreements which have been approved by the Central Government, be charged to tax at the flat rates specified in new Section 115A of the I.T.Act.

Under the provisions existing up to 31 May 1983, taxable income of foreign companies by way of royalties or fees for technical services received from Indian concerns is computed on a gross basis without allowing any deduction as discussed above. The same gross basis has been extended also to royalties and technical fees received on or after 1 June 1983 from the Government. This means the gross basis is now uniform for royalties and fees for technical services received by any foreign companies from Government and Indian concerns.

Interest income liable to tax in India was computed up to 31 May 1983, after allowing a deduction from the gross amount of interest of expenditure incurred wholly and exclusively for the purpose of earning such income, including interest on monies borrowed for such purpose. The deduction was not restricted to such expenses incurred in India only. Any such expenditure incurred outside India, such as interest paid or financing charges incurred for raising the monies advanced as loan was also allowable as a deduction in computing the interest income in India.

The law has been amended effective from 1 June 1983 by adding a new clause (c) to Sec. 44D. It states that no deduction shall now be allowed in computing taxable interest income of foreign companies received from Government or Indian concerns on monies borrowed or debt incurred by the Government in foreign currency. It shall be assessed on a gross basis like royalties and fees for technical services.

Computation of income from dividends (Sec. 57)

Up to 31 May 1976, income by way of dividends received by a foreign company was taxed on a net basis, that is, after allowing a deduction for expenses incurred by the company in earning such income. Foreign companies were also entitled to a deduction of 65% of dividend income received from domestic companies. As a result 35% of the net dividend income was charged to tax. The Finance Act, 1976 has amended Section 57 of the I.T.Act. It now specifically provides that no deduction will be allowed in computing income by way of dividends received by a foreign company. The gross amount of dividends will be charged to tax at the concessional flat rate provided in Sec. 115A.

Rates of tax on dividends, royalties, technical fees and interest (Sec. 115A)

Dividends received by foreign companies, as well as royalties, fees for technical services or interest received by them from Indian concerns in pursuance of approved agreements made on or after 1 April 1976, will now be charged to tax at flat rates applicable to the gross amount of such income. The rates of income tax to be applied in respect of such income have been specified in new Section 115A of the I.T.Act and are as follows:

(i) Prior to 1 June 1976, the net dividend income of 35% (after allowing 65% deduction under Section 80M) was charged at the rate of 73.5% applicable to foreign companies. This gave an effective rate of 25.725%. Dividends will now be charged to tax in the hands of the foreign company at the rate of 25% on a gross basis.

(ii) Royalties received under approved agreements made on or after 1 April 1976 will be charged to tax at 40%, on a gross basis, except that so much of such income as represents a lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property will be charged to tax at the rate of 20% of the gross amount of such lump sum consideration.

(iii) Fees for technical services received by a foreign company from an Indian concern in pursuance of an approved agreement made on or after 1 April 1976 will be charged to tax at the rate of 40% on the gross amount of such fees.

The flat rates specified above will, however, not be applicable in relation to royalties received by a foreign company from an Indian concern in pursuance of an approved agreement made on or after 1 April 1976 if such agreement is regarded as an agreement made before the said date under Section 9(1)(iv) of the I.T.Act. Such royalties will be charged to tax on a net basis at the rates specified in the annual Finance Act in respect of income by way of royalties and technical service fees received by foreign companies from Indian concerns under approved agreements made before 1 April 1976. The deduction of expenses incurred for earning such royalties will, however, be limited to 20% of the gross amount of such income.

From 1 June 1983, interest received by foreign companies from Government or Indian concerns on monies borrowed or debt incurred by the Government or Indian concern in foreign currency is taxable on a gross basis and is charged to tax at the rate of 25% applicable on the gross amount of such interest.

Double taxation relief (Secs. 90 & 91)

Section 90 of the I.T.Act empowers the Central Government to enter into an agreement with the Government of any foreign country:

(a) for granting relief in respect of income on which tax has been paid in India as well as the foreign country. The relief is granted after the income has been taxed under the laws of both countries;

(b) for avoiding double taxation. This relief is allowed at the time of the assessment itself. India currently has such agreements with more than 25 countries. The details of such agreements can be obtained from the Ministry of Finance of the country concerned or from the Central Board of Direct Taxes, New Delhi. Section 91 grants unilateral relief in India in respect of incomes which have been taxed both in India and a country with which India has no treaty for double taxation relief or for avoidance of double taxation. Broadly speaking, the relief is allowed at the Indian rate of tax or the rate of tax of the other country, whichever is lower. The relief is subject to the assessee producing proof that the income in question has been taxed in the other country.

Surtax

The Companies (Profits) Surtax Act levies a tax (called surtax) only on companies, whether Indian or foreign. It is leviable on the "chargeable profits" of the previous year which represent the total income of the company computed in accordance with the provisions of the I.T.Act as adjusted in terms of the First Schedule to the Surtax Act. The taxable amount is the sum by which the "chargeable profits" exceed the "statutory deduction" which broadly means 15% of the capital of the company calculated in terms of the second Schedule to the Surtax Act or 200,000 Rs., whichever is greater. The current rates are 25% on the chargeable amount up to 5% of the capital employed and 40% on the balance.

The aggregate of the net amount of income tax and surtax is limited to 70% of the total income in the case of a widely-held domestic company, namely, a company in which the public is substantially interested or a 100% subsidiary of such a company, provided the subsidiary is also a domestic company. In short, the ceiling of 70% does not apply to a foreign company even if it is a widely-held company.

Exemption from compulsory distribution of dividends (Sec. 104(4))

Under Sec. 104 of the I.T.Act closely-held companies are required, subject to certain exceptions, to distribute dividends up to a statutory percentage of their distributable income. Non-domestic companies are completely exempt from this requirement in view of the provisions of Subsection (4) of Sec. 104.

Wealth tax (Sec. 40 of Finance Act, 1983)

The W.T.Act came into force effective as of 1 April 1957. For three assessment years 1957-58 to 1959-60, wealth tax was also payable by companies but was discontinued thereafter. In paragraph 101 of his 1983 Budget Speech the Finance Minister observed that some persons have been avoiding personal wealth tax liability by forming closely-held companies to which they transfer many items of their wealth, particularly jewelry, bullion and real estate. To check this practice levy of wealth tax has been revived from 1 April 1984 in a limited way in the case of closely-held companies, whether Indian or foreign. Tax at the rate of 2% has been levied on their net wealth represented by specified assets such as jewelry, gold bullion, buildings, land and cars. Buildings used as a factory, godown (warehouse), hotel, office for business purposes or residential accommodation for low-paid employees is excluded from net wealth.

Foreign companies should carefully study this new provision and avoid falling under its purview by not owning any of the impugned assets situated in India.

Gift tax

Under the G.T.Act, a company, whether Indian or foreign, is liable to tax, unless it is specifically exempt. Sec. 45(c) of the G.T.Act exempts from tax a company, other than a private company, provided that the affairs of the company or shares in the company carrying more than 50% of the total voting power were at no time during the previous year controlled or held by less than 6 persons. A subsidiary of such company in which more than half the nominal value of equity share capital is held by such company is also exempt under Sec. 45(d).

A foreign company which does not fall outside the purview of the G.T.Act will be liable to gift tax if it transfers any movable or real property located in India voluntarily and without consideration in money or value. Generally speaking, a contribution to a political party or for political purposes may be subjected to gift tax.

Estate duty (Sec. 20A)

If a foreign company which carries on a business in India has been treated for income tax purposes as resident for two out of three completed assessments immediately preceding the death of a shareholder or debenture holder, it becomes an accountable person for the shares or debentures held by the deceased shareholder or debenture holder not domiciled in India at the time of his death. Section 20A of the E.D.Act casts duties and liabilities on such a company to furnish to the Controller of Estate Duty particulars under Rule 28 of the E.D.Rules about such shares and debentures and their holders within three months of the receipt of intimation of the death of the shareholder or debenture holder. It is also required to pay duty on the principal value of the shares and debentures as laid down in Part II of the Second Schedule to the E.D.Act. The duty is nil if the principal value does not exceed 5000 Rs. If it exceeds 5000 Rs., the rate of duty is 7½%.

Incidence of tax on foreign companies (Finance Act, 1983)

In the case of foreign companies, whether widely-held or closely-held, income from a Government or Indian concern by way of royalty agreements made after 31 March 1961 but before 1 June 1976 and agreements for fees for technical services made after 29 February 1964 but before 1 June 1976 is taxed at the rate of 50%. The rate of tax, on the balance, if any, of the total income is 70%.

The rates for domestic companies are somewhat lower. For a widely-held domestic company the tax rate is 55%. For a closely-held domestic company the tax rate is 60%, if it is an industrial company. Other closely-held domestic companies pay tax at the rate of 65%.

There is also a surcharge of 5% on income tax in all cases. Thus, the total incidence of tax on the income of a foreign company from sources other than dividends, interest, royalties, and technical service fees is 73.5% (70+5% of 70).

These rates are effective for the assessment year 1984-85.

Foreign oil companies

The I.T. and Surtax Acts contain some special concessions to attract foreign oil companies to India. Under Section 42 of the I.T.Act, if the Central Government or its nominee, such as the Oil and Natural Gas Commission, enters into an agreement with a foreign collaborator for prospecting, extraction and production of mineral oil or natural gas, the expenditure and allowances for calculating the taxable income of the foreign company shall be deducted in accordance with the terms set out in the agreement and not in accordance with the general provisions of the I.T.Act. Thus, the Government is authorised to give liberal allowances on a negotiated basis. Sec. 293A of the I.T.Act and Sec.24AA of the Surtax Act authorise the Government to accord concessional treatment even in the rate of tax. In pursuance of these powers the Government issued two notifications on 31 March 1983. Notification No. 306(E) reduces the tax rate, including surcharge, in the case of foreign companies from the normal rate of 73.5% to 56.375%. As per Notification No. 307(E), foreign companies engaged in prospecting, extraction and production of mineral oil and natural gas under agreements with the Government of India are exempt from payment of surtax. The above income tax concession and surtax exemption are available both in off-shore and on-shore areas.

Conclusion

Foreign companies operating in India or proposing to enter the vast Indian market should plan their tax strategies in the light of the legal provisions briefly noted here and involve themselves fully and expeditiously in India's economic advancement for mutual benefit.

KENYA:

The 1984-85 Budgetary Measures

An understanding of recent fiscal and monetary changes for the benefit of foreign investors

By Arthur A. Eshiwani, LL.B. (Hons.), LL.M.

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Introduction

In his budget speech on 14 June 1984 the Finance Minster gave a fairly positive evaluation of the general economic and political situation. Stressing the recovery of the international economy and the positive results to be expected from the Kenyan economy, he outlined the positive growth trends of the Gross Domestic Product, of per capita income, wage employment and investment.

The fiscal and monetary measures outlined below are contained in Finance Bill (No. 11/1984) which is expected to pass into law with no changes or amendments. The main themes of the 1984-85 Budget Speech were: (1) to re-orient local industry towards export trade. This is to be achieved through reduced customs and excise tariffs on raw materials used by industry, and above all through a re-alignment of the export compensation scheme. (2) Attraction of foreign investors is also a corner-stone of the fiscal measures. This is to be accomplished through increased rates at which foreigners would repatriate dividends and other earnings, easy access to local credit facilities and participation in the export compensation scheme.

a. The customs tariff

Changes in the customs tariff are aimed mainly at (i) re-orientation of the domestic industry towards export trade and (ii) attraction of foreign investment. There are two other minor themes – namely, discouragement of dumping on the domestic market and tariff adjustment to meet Kenya's obligations under the PTA Treaty.[1] In specific terms these are the proposed changes:

(1) Reduction[2] of duty on raw materials used in export oriented industries (in some cases the rates are to remain unchanged). To mention a few changes in the customs tariff:
- duty on the majority of imports which is currently chargeable at the rate of 25% or more is to be reduced by an average of 14% of the existing rate,
- duty on cereals, vegetable oils and fats to be reduced from 30 – 50% to 25 – 45%,
- duty on chemicals and related products to be reduced from 30 – 40% to 25 – 35%,
- duty on industrial machinery to be reduced from 30 – 40% to 25 – 35%,
- duty on passenger motor cars ranging from 50 – 170% to be reduced to 45 – 170%.

(2) To implement the PTA treaty, import and export duties on all items "on the common list of commodities to be traded in the PTA" are to be reduced by various percentages contained in PTA LN. N° 1/1984. There are other items to be traded tax free. These include livestock, poultry, beef, fish, milk and cream and eggs. [3] The reduced rates on PTA commodities took effect as of 1 July 1984.

(3) There are to be a number of administrative measures introduced to streamline administration of the customs tariff. The most significant is in the form of an amendment to S.46 of the Customs and Excise Act. S.46 heretofore provided that warehoused imported goods could only be re-warehoused once (after 6 months) with permission of the Commissioner for Customs. The Minister could, however, extend this period provided he issued permission for re-warehousing during the first 12 months of such warehousing. Beyond this period, nobody under the Act had power to extend the re-warehousing period. Upon expiration of the re-warehousing period, duty had to be paid on the goods or else they could be sold at auction. Due to administrative delays, *inter alia*, re-warehousing beyond the allowed period was inevitable. It was unfair to punish importers by auctioning their goods for errors beyond their control. The section is now amended to allow re-warehousing of goods not cleared within one year. The Minister can permit re-warehousing, but not more than once (S.2, the Finance Bill).[4]

b. The sales tax

There were significant changes in the area of Sales Tax; the overriding desire is still that of attracting foreign investment. But the changes are structured in such a way (through increases in Sales Tax) that the government regains what it loses by reducing the customs tariff. This tax is governed by the Sales Tax Act, Cap. 476. The changes include the following:

(1) – Classification of goods in the various schedules to the Act in such a way as to follow the classifica-

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1. Central and East Africa Preferential Trade Area; An Agreement amongst 14 States to reduce or dismantle customs duties among themselves. The 14 States will use local currency or barter in reciprocal trade in an attempt to save foreign exchange reserves. Reference: ATS, II; 18 TNS 6 (1984) at 49.
2. To take effect as of 1 July 1984.
3. See Kenya Gazette 6 July 1984 for details.
4. Excise Tax Measures, not included in the report, affected other commodities, such as beer and cigarettes.

tion under the First Schedule to the Customs and Excise Act, Cap. 472 for purposes of imposing fewer and standardised rates (S.11 of the Finance Bill). The standardisation of rates is meant to make the administration of the tax easier (p. 17 – Budget Speech).

- Tax rates on items on which import duty had been reduced are to be raised to the next standardised rate (except in cases where the general rate of tax applies or an item is exempt from tax) (S. 16 of the Bill amending 1st and 2nd. Schedules to Sales Tax Act).
- Tax rate on computers and other labour saving devices to be raised from 17% to 35%.
- Sales tax on nails, dry cell batteries and matches is to be removed. The removal of the tax on these items, especially on nails, was justified on the ground that the measure is meant ". . . to assist farmers and parents in completing primary school classrooms for the 8-4-4 system of education to be introduced next year . . ." (p. 17 Budget Speech).
- Tax rate on luxury items like photographic equipment, jewelry and domestic electrical appliances to be raised from 30 – 50% to 75 – 100%.

All these measures are detailed in the Fourth and Fifth Schedules to the Finance Bill, being an amendment to the First and Second Schedules to the Sales Tax Act respectively.

(2) Other measures relate to manufacturers importing raw materials. Customs duty on such materials is to be reduced as part of the Government's policy to encourage export oriented manufacturers. These manufacturers were entitled, under S.22 of the Sales Tax Act, to a refund of tax paid on imported raw materials (in the form of customs duty). To expedite the system of refund as a further measure to encourage industry, the Section is to be amended to the effect that instead of a check refund, the Commissioner of Sales Tax will now refund such a manufacturer by way of credit note. This was explained (at p. 17 of the Budget Speech) to mean that the Commissioner will now allow a manufacturer to deduct the equivalent amount of tax from the tax due on the following month's return. Of course, such deduction can only be upon prior permission of the Commissioner.

(3) The third measure was actually aimed at closing a loophole in the system of declarations due from manufacturers. The Minister (at p. 16) stated that under S.12 of the Sales Tax Act, a manufacturer was simply asked to declare the total taxable value of all taxable goods he had sold in the relevant month. This requirement did not take into account the fact that sometimes the declared value was a value on different types of goods and which had been sold at different prices. If separate goods attracted different tax rates, this blanket declaration did not enable the Commissioner to check the accuracy of the tax paid. S.13 of the Finance Bill now amends S.12 above by requiring that each manufacturer must now show rately tax particulars of total taxable value for each type of goods sold by him.

(4) In the aforementioned LN N°. 1 of 1984, tax rates on the list of common commodities are reduced in pursuance of one of the Protocols under the PTA Treaty (S.15 of the Finance Bill – amending to this effect S.24 of the Sales Tax Act).

c. Income tax

1. Equally beneficial to foreign investors is the change in SS. 34,35, of the Income Tax Act, Cap. 470 and the corresponding parts of the Third Schedule to the Act. The question of repatriation of dividend and other earnings by foreigners had become an important governmental concern in view of dwindling foreign exchange reserves. Realising that there was competition among developing countries to woo foreign capital, the Finance Minister decided to reduce the rates of withholding tax on non-residents where no tax treaty exists before remittance of the net payments to non-residents. This would serve to boost the total package of measures effected for the benefit of foreign investors. Withholding tax rates are, therefore, to be reduced as follows (S.21, Finance Bill):

- Royalties and management fees from 30% to 20%
- Rents: from 40% to 30%
- Dividends: from 20% to 15%
- Interest: from 20% to 12.5%

2. Another notable change in the law of income taxation is the change in the formulae for taxing incomes of cooperative societies and unions.

Instead of limiting itself to produce and marketing cooperatives only, the new rules now contain a number of different formulae applying to various types of cooperatives.

d. Export compensation

Foreign investors will benefit further by taking advantage of the now strengthened "export compensation scheme". The Local Manufacturers (Export Compensation) Act, Cap. 482 has been amended to strengthen the scheme. The thrust of the changes are to increase the rate of compensation for an exporting manufacturer. Before, the Act allowed exporters of eligible goods to claim 10% of the value of exports from the Customs and Excise Department. New exporters and additional exports were compensated at the rate of 15%. Under the new measures (1) the general rate of export compensation will be increased from 10% to 15%. (2) Additional exports and new exporters rate will be reduced from 15% to 10% (S. 17 of the Finance Bill amending First and Second Schedules to the Act accordingly). These measures took effect from 1 July 1984. According to the Minister, the need to promote exports "needs no emphasis" taking into account the fact that 1984 had been declared by the Government as "Export Year" (p. 21, Budget Speech).

e. Interest rates and financial institutions

The Minister restated the earlier announced[5] reductions in interest rates in order to increase bank credit and money supply. Thus the minimum interest rate on loans by commercial banks is to be reduced from 15% to 14%, the maximum interest rates chargeable by Financial Institutions to be reduced from 20% to 19% and the minimum deposit rate on savings to drop from 12½% to 11½% p.a.

In addition, non-bank institutions engaged in financial transactions, such as Building Societies and Hire-Purchase Companies, are to be subjected to regulations concerning the conditions of credit and the structure of their financial assets. Finally, private money lending was abolished through repeal of the Money Lenders Act, considered as no longer being in the public interest.

f. The air passenger tax

The Air Passenger Tax under the Air Passenger Tax Act, Cap. 475 was increased by approximately 40%.

The tax is to be paid in any convertible foreign currency equal to US $ 10 (S.23 of the Finance Bill amending S.3 of Cap. 475). For a foreigner this is to come out of his pocket; for a resident the tax is paid by deducting US $ 10 from the amount of foreign exchange allocated to him. To what extent this change will reflect on foreign exchange earnings is yet to be assessed. The Minister maintains that "this is not an onerous requirement".

5. The Weekly Review, Nairobi, 4 November 1983, at 31.

IFA news

Resolutions Buenos Aires IFA Congress 1984

At the end of the 38th IFA Congress in Buenos Aires (16-21 September 1984) the following Resolutions were adopted. Note that both resolutions were originally drafted in the English language. A translation in Spanish is included in the text below.

SUBJECT I: Fiscal Obstacles to the International Flow of Capital between a Parent and its Subsidiary

RESOLUTION (original version)

CONSIDERING:

That it is desirable that there be no fiscal obstacle to the international flow of capital between a parent and its subsidiary, this being particularly true in view of the investment needs of developing countries;

That a tax provision may constitute such an obstacle whether it intentionally or unintentionally impedes the flow of international investment;

That the taxation of the world-wide income of an enterprise, even with the application of the credit method for foreign taxes paid, generally puts an additional burden on foreign investments subject to lower effective taxation and may render ineffective the incentives granted by the country where the investment is made and therefore, may deter enterprises from making such investments;

That in view of the foregoing, a system of territorial taxation or of exemption of foreign income is preferable because it is more respectful of the sovereignty of states in tax matters, eliminates distortion of competition in the country where the investment is made, and therefore, does not impede the free flow of investment;

The General Report and the national reports submitted to the Congress, and the remarks made during its sessions;

THE XXXVIIIth CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION RECOMMENDS:

With respect to taxation in the country of residence of the parents:

That legislators in countries where a system of world-wide taxation is currently applied reconsider, in view of the foregoing, whether such system is the most appropriate in the circumstances;

That as long as world-wide taxation is maintained in a country, the credit method used to eliminate double taxation should include the following rules:

- credit relief based on the averaging of taxes paid to all foreign countries rather than limitation on a per country basis;
- unused foreign tax credit for any given year should be eligible for carry forward to future years and for carry back to previous years;
- recognition of tax incentives granted by other countries for the promotion of their economic development which takes the form of the procedures commonly referred to as tax sparing or matching credit not unduly restrictive in their scope of application;

With respect to taxation in the country of residence of the subsidiary:

That the taxation of the income of a parent company and its subsidiaries not resident in the same country be levied in each country on the basis of the profits realised by each separate entity and not on the basis of a proportion of the world income of the whole group such as the unitary taxation method;

That all payments which would otherwise constitute a deductible expense in computing the income of a subsidiary company if they were made to a company or person resident in the same country be deductible in the same manner and to the same extent when they are made to any non-resident, including a parent or associated company;

That since withholding taxes at source on the gross amount of any payment (such as dividends, interest, royalties) constitute a potential obstacle to the international flow of investment, the following rules should be applied:

- the rates of such taxes on gross payments should be as low as possible in all cases so as to reduce the risk of giving rise to such an obstacle, particularly if the net income of the recipient is subject to tax in his country of residence;
- whenever applicable, the recipient of the payment should be allowed to elect to be taxed on a net basis after deduction of all costs and expenses which can be established to the satisfaction of the competent tax authorities.

[Spanish version]

TEMA I: Obstaculos Fiscales el Flujo de Capitales entre Matrices y sus Filiales Extranjeras

RESOLUCION (version original: ingles)

CONSIDERANDO:

Que es deseable que no haya obstáculos fiscales al flujo internacional de capitales entre una empresa matriz y sus subsidiarias, lo cual cobra particular relevancia si se consideran las necesidades de inversión que tienen los países en vías de desarrollo;

Que una disposición legal en materia tributaria puede representar un obstáculo de tal naturaleza cuando, ya sea intencionalmente o no, interfiere con el flujo internacional de inversiones;

Que la imposición de la renta mundial de una empresa, -aún en el caso en que se le conceda crédito por los impuestos abonados en otros países-, en general representa una carga adicional sobre las inversiones en el exterior, cuando las mismas se hallan allí sujetas a una menor carga efectiva de imposición, al mismo tiempo que puede quitar eficacia a los incentivos fiscales concedidos por el país donde ellas se realizan, y en consequencia, puede disuadir a la empresa de efectuar tales inversiones;

Que, si se tiene en cuenta lo precedentemente expresado, un sistema de imposición de acuerdo con el principio de la territorialidad, o que no sujete a imposición a los ingresos obtenidos en el extranjero, es preferible porque respeta en mayor medida la soberanía tributaria de las naciones, elimina las distorsiones a la competencia en el país donde se efectúa la inversión, y, en consequencia, no interfiere con el libre flujo de las inversiones;

La ponencia general y las ponencias nacionales sometidas al Congreso y las observaciones realizadas durante sus sesiones;

EL XXXVIII CONGRESO DE LA ASOCIACION FISCAL INTERNACIONAL RECOMIENDA:

En los que respecta a la imposición en el país de residencia de la empresa matriz:

Que los legisladores de los países en donde como regla general se somete a tributación la renta mundial reconsideren, de acuerdo con lo precedentemente expuesto, si tal criterio es el más apropiado a las circunstancias;

Que, en la medida en que en un determinado país se mantenga el criterio de someter a tributación la renta mundial, el método de crédito de impuesto que se utilice para eliminar la doble imposición, debería incluir las siguientes reglas:

- El crédito debe concerderse según el total de impuestos abonados al conjunto de países extranjeros, y no limitado individualmente por país;
- Debe permitirse opcionalmente que el crédito fiscal no utilizado en determinado período fiscal pueda ser transferido a períodos fiscales futuros o a períodos fiscales precedentes;
- Deben reconocerse los incentivos fiscales concedidos por otros países para su crecimiento económico, mediante la adopción de procedimientos comúnmente conocidos como "tax sparing" o "matching credit", al mismo tienpo que no debe restringirse indebidamente su aplicación;

En lo que respecta a la imposición en el país de residencia de la subsidiaria:

Que la imposición de la renta de una empresa matriz y de sus subsidiarias no residentes se efectúe sobre la base de las ganancias realizadas por separado por cada entidad en cado uno de los respectivos países, y no sobre la base de proporcionar la renta mundial de todo el conjunto, como implicaría la aplicación del llamado método unitario de imposición (unitary taxation method).

Que todos los pagos que constituyan gastos deducibles en la determinación de la renta de una subsidiaria cuando se efectúen a sociedades o individuos residentes en el mismo país de la subsidiaria, sean igualmente deducibles, de la misma manera y con los mismos alcances, cuando se efectúen a no residentes, incluso cuando lo sean a una empresa matriz o asociada;

Que dado que la imposición mediante el sistema de retención en la fuente aplicado sobre el importe bruto de la renta (tales come dividendos, intereses, regalías) constituye un obstáculo potencial al flujo internacional de inversiones, deberían aplicarse las siguientes reglas:

- las tasas de impuesto aplicadas sobre el importe bruto de la renta deberían en todos los casos ser lo más bajas posibles, de forma de reducir el riesgo de que constituyan tal tipo de obstáculo, en especial si la renta neta del beneficiario está sujeta a impuesto en el país de su residencia;
- en todos las casos apropiados, debería concederse al beneficiario de la renta la opción para que el impuesto se aplique sobre la renta neta, o sea, después de deducir de la renta bruta todos los costos y gastos que puedan determinarse cumpliendo lòs requisitos que establezcan las autoridades fiscales competentes.

SUBJECT II: Social Security Contributions as a Fiscal Burden on Enterprises engaged in International Activities

RESOLUTION (original version)

CONSIDERING:

That enterprises engaged in international activities are commonly faced with different systems of financing compulsory public programmes of social security benefits in different countries;

That even in the case of programmes which are financed in similar ways, significant differences often exist;

That the financing of social security benefits on the basis of contributions based on salaries is being supplemented in many countries by significant contributions from the general treasury of the public sector; that this development has given rise to concern over the economic effects of such social security systems; and that there exists no uniform opinion among economists on those effects because of the lack of sufficient theoretical and empirical evidence;

The General Report and the national reports submitted to the Congress, and the remarks made during its sessions;

THE XXXVIIIth CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION RECOMMENDS:

That international solutions should be developed to reduce substantially the difficulties of enterprises engaged in international activities arising from differences between systems of compulsory contributions that finance social security benefits;

That despite the existence of unilateral measures adopted by certain countries (which frequently differ from each other), a draft Model Convention with respect to social security should be prepared by the most appropriate internationally accepted body or bodies, aiming at a more uniform and a more extended network of bilateral or multilateral social security agreements;

That the power to impose compulsory contributions should be with the country where the work is performed (territorial principle), except when work is performed for a relatively short period by an individual who has been sent there from another country, and in that instance the country from which the individual is sent should continue to impose its compulsory contributions; that the length of such short periods should be standardised as much as possible; and that the country from which the individual is sent should obtain assistance from the country of temporary employment in the collection of its proper social security contributions over such short periods;

That the free transfer of social security benefits to a non-resident beneficiary should be guaranteed by the payor country where that country as the country where work is performed is entitled to collect social security contributions;

That further research be undertaken to study the long term social and economic effects of financing social security benefits by means of contributions other than those based solely on salaries.

[Spanish version]

TEMA II:
Las Contribuciones de Seguridad Social como Carga Fiscal sobre las Empresas que desarrollan actividades internacionales

RESOLUCION (version original: ingles)

CONSIDERANDO:

Que las empresas que desarrollan actividades internacionales están comunmente enfrentadas con sistemas diferentes para el financiamiento de programas públicos compulsivos de beneficios de seguridad social, en diferentes países;

Que aún en el caso de programas que son financiados con métodos similares, a menudo existen diferencias significativas;

Que la financiación de los beneficios de seguridad social sobre la base de contribuciones sobre salarios está siendo complementada en muchos países por contribuciones significativas del Tesoro General del Sector Público; que esa modificación ha despertado el interés sobre los aspectos económicos de cada uno de los sistemas de seguridad social y que no existe opinión uniforme entre los economistas en relación a estos efectos por falta de base teórica y empírica suficiente;

La ponencia general y las ponencias nacionales sometidas al Congreso y las observaciones realizadas durante sus sesiones;

EL XXXVIII CONGRESO DE LA ASOCIACION FISCAL INTERNACIONAL RECOMIENDA:

Que deben promoverse soluciones internacionales para reducir substancialmente las dificultades de empresas que desarrollan actividades internacionales, originadas en las diferencias entre los sistemas de contribuciones compulsivas que financian los beneficios de seguridad social;

Que a pesar de la existencia de medidas unilaterales adoptadas por ciertos países (que frecuentemente difieren unas de otras) los organismos internacionales más apropiados deberían preparar un modelo de convención impulsando una más extensiva red de acuerdos bilaterales o multilaterales de seguridad social;

Que el poder de imponer contribuciones compulsivas debe estar en el país donde el trabajo se realiza (principio territorial) excepto cuando una persona enviada desde otro país realiza trabajo por un período relativamente corto; que en tal caso el país desde el cual la persona ha sido enviada debe continua con la imposición de las contribuciones compulsivas; que la duración de esos cortos períodos debe ser estandarizado todo lo posible; y que el país desde el cual la persona es enviada, debería obtener apoyo del país de empleo temporario en la recaudación de las contribuciones de seguridad social apropiadas a lo largo de esos cortos períodos;

Que la libre transferencia de los beneficios de seguridad social a un beneficiario no residente debe ser garantizado por el país pagador como el país donde el trabajo fue realizado y está habilitado para recaudar las contribuciones de seguridad social;

Que debe realizarse más investigación para estudiar los efectos sociales y económicos en el largo plazo, de financiar los beneficios de seguridad social por medio de contribuciones diferentes de las basadas únicamente sobre los salarios.

DUTCH BRANCH

On 5 October 1984, the Netherlands group of I.F.A. gathered in the Amsterdam maritime museum for its annual general meeting.

Apart from the usual topics on the agenda of any general meeting (approval of accounts, admission of an impressive list of new members and fixing next year's membership fees), the major subject was a discussion of the draft national reports for the 1985 IFA Congress in London.

Although, as usual, it was stressed by the Chairman that the national reports are the exclusive personal responsibility of the authors, members present were invited to submit their remarks and suggestions on the draft reports and a sometimes lively discussion emerged.

The two reports, by Mr. H.M.M. Bierlaagh on "The assessment and collection of tax from non-residents in the Netherlands" and by Mr. W.E. de Vin on "International double taxation of inheritances and gifts" will undoubtedly find their way to the 1985 IFA Cahiers.

After the meeting, a very pleasant lunch and boat trip for members and guests were arranged on board a magnificently renovated paddle steamer, a refreshing end of a busy day.

Nigeria's Revised Budget for 1984

By S.O. Olifin

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I. INTRODUCTION

On 7 May 1984, the Head of the Federal Military Government of Nigeria, Major General Muhammadu Buhari, presented a revised Budget for 1984. Our discussion of this Budget is divided into four parts. The first part consists of an introduction outlining the policy objectives and rationale for a second Budget within a given year. In section II we discuss the economic background to the Budget; in a third section we examine some of the specific measures envisaged in the Budget and in a fourth and final section we briefly analyse the budget and draw some tentative conclusions.

Just before the change of administration, brought about by a military coup in January 1984, the ousted civilian administration had in the preceding December presented its 1984 Budget. Two major reasons were advanced for revising the earlier Budget proposals. First there was the need to reflect the realities of the present financial predicament of the country, and secondly, there was also the need to reflect the priorities of the new military administration. The major guiding principles underlying the new Budget were stated as, (i) matching expenditure with resources, i.e. pursuing a policy of balanced budget, (ii) reducing Government spending and (iii) cutting waste. Measures announced in the Budget are geared towards realising three major policy objectives which are:

(a) to arrest the decline in the economy;
(b) to put the economy on a proper course of recovery and solvency; and
(c) to chart a future course for economic stability and prosperity.

The specific policy instruments for achieving these desired objectives were listed as:

(i) reduction in Government spending;
(ii) reduction in the level of imports;
(iii) revival of agriculture;
(iv) resuscitation and streamlining of industries;
(v) stabilization of prices and incomes;
(vi) intensification of revenue drive in order to broaden the revenue base of the Government; and
(vii) restoration of confidence in the Nigerian currency, the Naira.

II. GENERAL ECONOMIC BACKGROUND

The Nigerian economy, like most other developing economies whose external sector accounts for a high percentage of total GDP (roughly 40% for Nigeria), has been suffering from the inevitable transmission of the impact of the general global recession, particularly in the advanced industrialised countries of the West that provide a market for her single most important export commodity, i.e. crude petroleum, and the supply of her imports of consumer goods, as well as capital goods for promoting desired rapid industrialisation. This vulnerability of the economy to any major external shocks from her major trading partners has been attributed to the growing dependence on the external sector, reflected in the growing percentage share of imports and exports in total GDP. The value of imports plus exports as a proportion of total national income is thought to have grown from 26% in 1970 to 41% in 1981. The gradual recovery of Western economies notwithstanding, the prospect for a major recovery in the oil market is not seen to be bright as Nigeria's Opec oil market share is not likely to change significantly compared with the current recession levels. Hence the Government is desirous of a reversal in the growing trend of undue reliance on the external sector, particularly the export of crude petroleum.

As a reflection of the general decline in the level of economic activity, most of the major economic indicators as shown in Table 1 below recorded negative growth between 1982 and 1983 partly as a result of the impact of the global recession, partly as a result of the gross mismanagement of the economy by the ousted civilian administration, and partly as a result of unfavourable weather conditions and pests which affected food production. The decline in agricultural production led to increased importation of food and raw materials such as rice, maize, vegetable oil, palm produce and cotton, among other raw materials some of which were once

TABLE I
Major economic indicators

	1982	1983	Growth %
Overall GDP	28.5 (bill. ₦)	27.3 (bill. ₦)	−4.4
Contribution of oil to GDP	4.4 (bill. ₦)	4.1 (bill. ₦)	−7.0
Level of oil production	1,289 (m.b.d.)	1,235 (m.b.d.)	−4.2
Export of crude oil	1.009 (m.b.d.)	0.935 (m.b.d.)	−7.3
Selling price of oil	35.5 ($.p.b.)	30.0 ($.p.b.)	−15.5
Contribution of Manufacturing to GDP	2.359 (bill. ₦)	2.300 (bill. ₦)	−2.5
Contribution of Construction to GDP	–*	–	−8.4
Contribution of Transport to GDP	–	–	−7.7
Contribution of Communication to GDP	–	–	−4.9
Government revenue	10.9 (bill. ₦)	8.6 (bill. ₦)	−21.8
Level of imports	12.6 (bill. ₦)	9.7 (bill. ₦)	−23.0
Level of exports	8.7 (bill. ₦)	7.6 (bill. ₦)	−12.6
Deficit in the current account of BOP.	5.2 (bill. ₦)	3.4 (bill. ₦)	−34.6

* Provisional figures not available.

major contributors to agricultural exports. The sudden drop in Government revenue forced deficit budgeting on both the Federal and State Governments. This meant inevitable heavy public borrowing to meet recurrent expenditure of paying wages and salaries. An estimate by the Minister of Finance puts the figure of Government foreign indebtedness at about ₦ 5.293 billion (US$ 7.040 billion).

III. FISCAL, MONETARY AND OTHER POLICY MEASURES ENVISAGED IN THE BUDGET

Fiscal policy measures

There are at least seven specific fiscal policy measures aimed at encouraging growth in manufacturing, reducing the level of unemployment and cutting down on Government sector involvement in directly productive economic activities. These include:

(i) a reform of the customs and excise tariff to provide effective protection for local manufacturing industries, reduce the level of unemployment, and enable the Government to diversify its revenue sources away from dependence on oil revenue;

(ii) the range of import duties has been reduced from a 0-500% range, to a narrower range of 5-200%;

(iii) to encourage inflow of investment capital, a more stable tariff structure is being introduced which will be kept in place for a minimum of three years;

(iv) duty exemption on imported manufactures has been reduced from 38 imported items to twenty of such items. Similarly the concessionary rates of duty which granted zero duty to some manufacturers has been abolished, with rates of duty of between 5 and 10% being introduced for some items previously exempted from duty;

(v) to encourage investment in agriculture and thereby increase domestic food production, and production of raw materials for the manufacturing sector, duties on selected imported agricultural products have been raised to protect producers, while duties on machinery and equipment for exclusive use in agriculture are being abolished;

(vi) to encourage export of locally manufactured products, appropriate concessions and assistance schemes are being worked out to assist local manufacturing industries with export potentials;

(vii) also the reform of Government owned companies and quasi-Government companies is underway, to reduce their dependence on Government funding, and transform them into profit making, self-supporting ventures;

(viii) finally, as an interim measure to supplement domestic shortfall in essential commodities, import duties are being removed on medical preparations, medical equipment, life saving devices as well as the importation of wheat and tea.

Monetary policy measures

Monetary policy measures envisaged in the Budget are intended as measures to re-inforce other economic policy measures aimed generally at improving the balance-of-payments (BOP). This desired improvement in the BOP, it is believed, would be achieved if appropriate measures can be taken to clear the accumulated backlog of short term trade debts, build up external reserves to a reasonable level, reduce inflationary pressures in the economy and encourage the expansion of domestic output of essential goods and services. A tight monetary policy is considered necessary if these objectives are to be realised. Accordingly a new credit guideline for 1984 has been introduced which will lower the permissible maximum rate of credit expansion. To encourage domestic savings, and ensure a more efficient allocation of scarce resources, the existing interest rate structure is being adjusted, raising the deposit rate from 6½ – 8% to 8½ – 10% and the minimum lending rate is raised from 8½ – 10% up to a ceiling of 13%. The on-going rural banking programme aimed at monetizing the largely subsistence rural sector economy is to be pursued vigorously.

Increasing Government revenue through better tax administration

One major reason why the Governments in most developing countries do not often rely on direct taxes as sources of Government revenue is because of the numerous problems encountered in administering such taxes and the high incidence of tax evasion. It is easier for the Government to rely on indirect tax revenue mainly by way of import and excise duties and royalties from mining concessions and export duties. In this regard Nigeria is not an exception. Being a military administration, the present Government plans to take stern measures to combat tax evasion and increase Government revenue from both direct and indirect taxes as indicated in the following broad statement of policy in the revised Budget:

> Collection of taxes is to be intensified and sanctions against tax evasion and any malpractices is to be strictly enforced. A decree is to be promulgated to effect some amendments in the country's tax laws to make tax administration more effective and reduce tax evasion.

In addition to these broad guidelines some of the specific measures to be implemented at the Federal level include the following: first, the now outdated 1958 Customs Act on which taxation of the oil sector is based is to be revised so as to plug existing loopholes which some companies take advantage of to evade taxes. Secondly, customs procedures are to be streamlined to enhance efficiency in duty collection while additional excise duty collection centres are to be established. The entire Federal Customs Department is to be reorganised, and better training and equipment is being offered to customs officers to enable them to combat smuggling. Surveillance groups are to be established also in the bid to check unscrupulous importers and exporters who evade taxes.

Excise duties have hither to accounted for less than 3.7% of total Government revenue. As part of the new measures to tap this potential source of increased revenue, low import duty rates hitherto granted to manufacturers are to be abolished, and excise duty rates ranging from 60 – 150% are being imposed on domestic manufacture of about 400 items, with non-essential commodities such as alcoholic beverages, tobacco and spirits attracting the highest rates. Similarly imported equivalents covering a total of about seventy items which have hitherto attracted specific taxes, are to attract ad valorem rates of duty ranging from 25% for essential commodity imports such as food, to 150% for luxury items such as alcoholic beverages. All other tangible items of import are being placed under specific import duties.

The ramifications of the stern measures contemplated in the Budget Speech are already being felt at the State and local Government levels. These measures imply that the Government is going to resort to both conventional as well as non-conventional measures to combat tax evasion. As an illustration during the recently completed currency change exercises, people with lodgements exceeding ₦ 5,000 (US$ 6,650.0) were required to provide evidence of tax payments for the preceding three years. Lack of such tax clearance, or evidence of underpayment of taxes, automatically reduced the amount deposited to taxable income. The appropriate tax was there and then deducted before the balance was credited to the depositor's account.

At the State and local Government levels, the ousted civilian Government introduced a form of tax administration which, if effectively implemented, would have greatly reduced the incidence of tax evasion. This measure required that evidence of payment of taxes for three consecutive years preceding the current year be presented without which access to most Government services such as health care, education, and enjoyment of various forms of Government patronage such as award of Government contracts, purchase of foreign exchange, import licence, registration of property and numerous other dealings with the Government would be denied. Political considerations during the civilian era introduced loopholes into the effective implementation of this anti-tax evasion measure. As part of the measures to combat high occurrence of tax evasion this measure is to be rigidly enforced. Also various arms of the armed forces, like the police and army personnel, are to be deployed to supervise tax collection. It is to be expected that the various forms of taxation aimed at the urban and rural poor such as cattle tax, poll tax and flat rate taxes, abolished by some State Governments in the civilian Government era will be reintroduced. To combat inflation, it is likely that sales tax already successfully introduced by one of the State Governments in the civilian Government era is likely to be abrogated. Some new forms of indirect taxation, such as property tax, entertainment tax aimed at curbing extravagant conspicuous consumption habits of the well-to-do are already being contemplated in some of the states. Some of the measures at the State and local Government levels will specifically be aimed at generating sufficient revenues to finance various Government services such as health and education services, that were purportedly run as free services in some States by the outgoing civilian administration.

Government revenue and expenditure and State allocations

Recurrent expenditure

Total Federal Government revenue for 1984 is estimated at ₦ 11.311 billion (US$ 15.044 billion). Of this amount ₦ 5.607 billion (US$ 7.457 billion) or 49.57% is to be retained for Federal Government spending while ₦ 3.109 billion (US$ 4.135 billion) or 27.49%, and ₦ 1.09 billion (US$ 1.450 billion) or 9.64% are being allocated for meeting State and local Government spending respectively. When account is taken of the independent revenue of the Federal Government, its total revised revenue estimates for 1984 stand at ₦ 6.744 billion (US$ 8.969 billion). In pursuance of the desired reductions in Government spending all tiers of Government are to pursue a balanced Budget policy and possibly aim at considerable reduction in Government spending that would lead to a surplus on the recurrent expenditure side of Government spending. Thus the Federal Government's total recurrent expenditure for 1984 is to be ₦ 6.07 billion (US$ 8.073 billion). This represents a 17% and 15% reduction respectively, relative to the 1983 Budget and the ousted civilian Budget estimates for 1984.

Capital expenditure

The new Budget allows ₦ 3.93 billion (US$ 5.227 billion) for Federal Government capital expenditure outlay for 1984, compared with the figure of ₦ 6.59 billion (US$ 8.765 billion) for 1983 and ₦ 4.66 billion (US$ 6.178 billion) in the scrapped 1984 Budget. This represents a sharp reduction by about 40.3% and 15.6% respectively. Of this amount ₦ 1.795 billion (US$ 2.387 billion), or nearly 46% is to be financed from external loans while the balance is expected to be raised from domestic loans and surplus from the recurrent expenditure account. A Capital Projects Review committee has been set up to make recommendations on the streamlining of the existing various capital projects embarked upon by the ousted civilian administration. In addition, except in very exceptional cases, no new capital projects are to be embarked upon either by the Federal or State Governments. This is to curtail the need for external borrowing.

Balance-of-payments and foreign debts

In the 1983 fiscal year, total foreign exchange earnings mainly through exports was ₦ 8.45 billion (US$ 11.239 billion) whereas the import bill on goods and services stood at ₦ 10.921 billion (US$ 14.525 billion). This meant a BOP deficit of ₦ 2.471 billion (US$ 3.286 billion). Total foreign exchange receipts in 1984 estimated to be ₦ 8.796 billion (US$ 11.698 billion) out of which ₦ 8 billion (US$ 10.640 billion) is being earmarked for import of goods and services and meeting debt servicing obligations. It is expected that the surplus will increase the level of external reserve to about ₦ 1.21 billion (US$ 1.609 billion) by the end of the year. To conserve foreign exchange, the various control measures introduced earlier in the year to cut down expatriate service fees, basic business travels, medical allowances and overseas studies remain in force. In addition the percentage of net income allowed as home remittance to expatriates employed in the country is being reduced further from 50% to 25%.

Total external indebtedness of the country as of 31 March 1984 stood at ₦ 8.30 billion (US$ 11.039 billion). To maintain the country's credit worthiness, the level of total external indebtedness is to be kept under strict control. Based on estimated foreign exchange receipts of ₦ 8.796 billion (US$ 11.698 billion) for 1984 and an estimated ₦ 2.50 billion (US$ 3.325 billion) annual requirement for principal and interest repayments between 1984 and 1986 the debt service ratio stands at roughly 28.42% for 1984.

While negotiations with the International Monetary Fund and the World Bank are to continue towards securing loans to alleviate short term BOP difficulties, no new external borrowing for capital expenditure purposes is envisaged other than those needed to pursue capital projects spill overs from 1983.

Sectoral programmes in key sectors

To boost production in agriculture, the sum of ₦ 20 million (US$ 26.6 million) is being set aside for provision of water supplies, supplementary feeds and repair of agricultural tractors and machinery. Existing river basin development authorities are to be reorganised for better effectiveness. Small-scale traditional farmers are to be granted easier access to credit, more efficient provisions of inputs, and higher producer prices. Large scale farming is also being encouraged by allowing up to 80% of foreign investment participation in large farm projects.

In the petroleum sector a sum of ₦ 327.94 million (US$ 436.160 million) is being allocated to financing development projects which include further exploration for crude, petrochemicals, an additional refinery, and Liquefied Natural Gas projects.

In the manufacturing sector, as much of the Government's overall policy is to restrict direct Government participation while encouraging private sector initiative, it intends to be involved in areas of industrial development that are considered to be of the highest priority. Some of these include paper mill projects, machine tool industry, fertilizer projects and sugar manufacturing. The general programme for the industrial sector includes providing incentives for industries using local raw materials, continued assistance to small-scale industries, and general promotion of private investment. Depending on the availability of foreign exchange, priority is to be given to the import of raw materials and spare parts needed by manufacturing industries. Export promotion is also to be given special attention. Other indirect measures designed to bring about the establishment of a sound industrial base include the completion of the various steel development projects already embarked upon, improvements in electricity generation and distribution, and giving priority to the development and provision of reliable and efficient transportation systems by rail, road and water to enhance an early and orderly recovery of other sectors of the economy.

IV. BRIEF ANALYSIS AND SOME CONCLUSIONS

Judging by comments on the Budget by a wide spectrum of society ranging from the average self-employed urban dweller, the labour unionists to the industrialists, the general feeling appears to be that on the whole, the Budget is not only realistic but also sensible, some of its tough measures notwithstandinng. The various restrictions and controls are seen as being inevitable if the economy is to be put on a path of recovery. The Government's overriding concern in ensuring that expenditure programmes are related to available means and resources is generally welcome. It is in effect the first Budget in several years that has not envisaged a large deficit. The renewed emphasis on agriculture which before the first oil shock was the mainstay of the economy may be seen as a right step towards achieving the now much desired diversification away from oil exports. Some reservation is, however, being expressed in several quarters regarding the invitation to foreign investment participation to the tune of 80% involvement in large scale farming investment projects. The deliberate attempt to enhance the productivity of the rural peasant farmer may alleviate some of the unemployment problems that closure of non-viable projects, particularly in manufacturing, may bring about. This pre-supposes that a movement back to the unattractive rural areas can be achieved.

In the manufacturing sector it can be expected that the overall effect of the industrial development measures introduced would lead to a collapse of certain industries particularly those that rely either solely or heavily on import of raw materials. Also the raising of the level of interest rates may lead to increased costs of production which may reduce profits margins if not passed on to consumers in higher prices. Notwithstanding their net effect on manufacturing, these measures are likely to bolster local industry, especially those businesses which rely on local raw materials. The Budget may be seen as a vote of confidence in the private sector in that the Government envisages a recovery through reductions in Government spending and the reduction in its involvement in directly productive economic activities.

U.S.A.: Foreign Sales Corporation

The Successor to DISC

By John R. Beattie and Leonard W. Rothschild, Jr.

This is the second part of a two-part article of which the first part appeared under the title "U.S. expected to replace DISC with new Foreign Sales Corporation" in 37 Bulletin for international fiscal documentation *8 (1983) at 339.*

Shortly after the enactment of the Domestic International Sales Corporation (DISC) legislation in 1971,[1] several U.S. trading partners lodged protests under the General Agreement on Tariffs and Trade (GATT) in an effort to force the repeal of the new income tax "incentive" for American exporters. The protests stemmed, in part, from the perception that the DISC tax deferral violated GATT's rule prohibiting direct government subsidies of exports.[2] After much debate, the United States signed a multinational agreement in 1981 which dealt a deathblow to the continued existence of DISCs. Last July, new legislation was enacted establishing a new export incentive system, Foreign Sales Corporations[3] (FSC), to replace the controversial DISC.

The DISC export incentive involved a deferral of a portion of the income tax on the DISC's income, provided the DISC met both a gross receipts test, and the increasingly troublesome export asset test. The DISC deferral was limited for many larger exporters by the imposition of the DISC "incremental rule" in 1976.[4] The benefit of the DISC deferral accrued to the DISC shareholders. The DISC itself paid no taxes, and profits attributed by the exporter to the DISC generally were not taxed until an actual distribution (or deemed distribution) was made to the DISC's shareholders. A portion of the DISC's profits could be accumulated tax-free in the DISC even if the entity functioned only as a mere accounting mechanism, existing only on paper.[5]

Although the ultimate goals and effect of the FSC legislation are similar to those of the DISC provisions, the means by which they are achieved are quite different. Instead of the DISC tax deferral, FSCs will be eligible for a permanent exemption of tax on a portion of their export receipts. The FSC, not its shareholders, will pay U.S. tax on the nonexempt portion of its income. FSC dividends from export trading income would be tax exempt to a U.S. parent company.

Perhaps the most significant provisions of the legislation are those requiring an FSC to meet rather strict foreign presence and foreign economic processes tests. These tests are intended to force an FSC to comply with GATT rules permitting a tax exemption for export income only if the economic processes which create the income occur outside of the United States. However, to comply with these rules, most American exporters will incur higher administrative costs, and will lose the administratively convenient DISC "paper entities". Fortunately, unlike DISCs, FSCs will not be subjected to the annual gross assets and gross receipts qualification tests that too often proved to be a nuisance for exporters who had difficulty sheltering tax deferred DISC income in qualified assets.

In addition to the foreign presence and foreign economic processes requirements, the FSC legislation also establishes safe haven transfer pricing rules, similar to those used by DISCs, for computing taxable income that can be allocated to the FSC.

A very important provision of the FSC legislation, which has already caused some outcry by several GATT members, calls for the permanent forgiveness of tax on prior accumulated DISC income. DISC critics may perceive this permanent waiver as vindication of their argument that DISC rules were truly a tax subsidy cloaked in the guise of a tax deferral.

HOW AN FSC WORKS

The essence of FSC tax benefits is that a portion of the exporter's profits can be allocated under safe harbor transfer pricing rules to a foreign subsidiary. That "outbound" shifting of profits reduces the exporter's U.S. taxable income. The FSC is subject to U.S. income taxes on only a specified portion of its allocated profits; the remainder of the FSC's export profits are exempt from U.S. income taxes. Furthermore, a U.S. corporate shareholder is exempt from taxation on dividends received from the FSC to the extent the dividends are paid from foreign trading income. As a result, otherwise taxable income from export sales is shifted to the FSC where U.S. taxation is imposed on only a portion of such profits.

Two basic safe haven transfer pricing options (with important technical offshoots) generally permit the greater of 1.83% of export revenue or 23% of export profits to be assigned to the FSC under the safe harbor transfer pric-

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1. Internal Revenue Code of 1954 (I.R.C.) Sections 921-997.
2. Cohen & Hankin, "A Decade of DISC: Genesis and Analysis." 2 *Virginia Tax Review* 7, 25 (1982) (Hereinafter Cohen).
3. Tax Reform Act of 1984, Pub. L. No. 98-369, 98th Cong. 2d. Sess., Act Sections 801 (adding I.R.C. Sections 921-927) through 804. Enacted July 18, 1984. All references will be to the Internal Revenue Code of 1954.
4. I.R.C., Sec. 995 (e).
5. Cohen, supra note 2, at 25-29.

ing rules. In either case 15/23 (or 16/23 for noncorporate shareholders) of the FSC's allocated profits are exempt from U.S. taxation. For this reason many commentators distill these rules into a generalization that 15% (15/23 x 23%) of export profits escape tax under FSC provisions. With marginal U.S. corporate tax rates at 46%, the FSC tax savings can approach 6.9% (46% x 15%). However, on FSC profits derived from safe harbor pricing rules, no credit for foreign income taxes is allowed to the FSC or its dividend-receiving U.S. parent. Hence, any foreign taxes on FSC profits generally erode the potential 6.9% tax savings.

In order for a corporation to be eligible for the FSC partial tax exemption, it must meet the qualification requirements described in the legislation.[6] In contrast to its DISC ancestor, a FSC must be created or incorporated under the laws of a "qualified foreign country" or U.S. possession (except Puerto Rico). A "qualified foreign country" is one having an exchange of information agreement with U.S. taxing authorities which has been certified by the Secretary of the Treasury as achieving the Internal Revenue Service's standards.[7] Although many nations have such agreements included in income tax treaties with the United States, as of 30 September 1984 none of these agreements has been certified. Until certification occurs, it is risky and, perhaps, futile to incorporate a FSC in a foreign country. Consequently, exporters seeking FSC benefits have focused much of their attention on the permissable U.S. possessions as likely sites for their FSCs.[8] The U.S. possessions are particularly attractive to exporters because the legislation prohibits the possessions from imposing an income tax on FSC earnings before 1987. However, with the possible exception of the U.S. Virgin Islands, exporters have recognized certain practical inadequacies of most of these sites, including geographical isolation and the lack of adequate communications.

Furthermore, since the FSC is required to maintain an office outside the United States,[9] the location of the FSC's principal office must offer good financial and computer systems, as well as access to capable professional advisors. Because it was the intention of Congress that the FSC's foreign office constitute a "permanent establishment" under income tax treaty concepts,[10] the foreign office is required to maintain a permanent set of tax records, including invoices. A FSC may share its office with other FSCs and need not maintain its office where it is incorporated. Though this provides exporters with some degree of planning flexibility and reduced administrative costs, as a practical matter, exporters should be wary of triggering taxation by the country in which the FSC's office is maintained. Therefore, despite their perceived shortcomings, the U.S. possessions retain, at least until 1987, much of their attractiveness as sites for FSC foreign offices.

To help alleviate the negative perceptions shared by exporters, and to take advantage of the profitable opportunities associated with FSCs, a number of service organizations have blossomed in the U.S. possessions to handle the potential influx of FSC business. Some doubt exists as to whether these service organizations can, by agency, create the necessary permanent establishment for an FSC. Most likely, a contracted servicing group could provide many of the computer and communication services necessary for the effective and efficient compliance with the FSC foreign office requirement. Presumably, these organizations would also provide an office complex which would contractually serve as the office for numerous FSCs. While this arrangement might seem to fall short of constituting a "permanent establishment" because of the agent's independence,[11] the probability of strong home office control over the agent's activity should overcome "independent" status. Therefore, a service organization participating in sales contracting in a fiduciary capacity under detailed instructions from the FSC should reach the threshold of "permanent establishment" status.[12]

Some U.S. possessions are considering legislation to provide FSCs with some degree of certainty in the realm of local corporate law and tax ramifications. The U.S. Virgin Islands, for example, is considering legislation[13] which would impose a 0.85% or less (after 1986) tax on the export income of an FSC,[14] and require all FSCs incorporated under its law to hold annual directors' meetings locally.[15]

FSC legislation also requires that, for every day of the taxable year, the FSC have at least one director who is not a U.S. resident. Since the nonresident can be a U.S. citizen, this requirement loses some of its harshness, particularly for larger U.S. exporters with employees currently overseas. To guard against the unforeseen death or resignation of a nonresident director during the taxable year (and the resulting loss of FSC benefits) exporters should consider having more than one nonresident director. This precaution may, in fact, become a necessity if the jurisdiction in which the FSC incorporates requires more than one resident director and institutional directorships are not recognized. The need for this precaution against inadvertent loss of FSC benefits should be balanced against the possibility that the existence and activities of multiple nonresident directors may trigger taxation of the FSC in the jurisdiction where those directors reside. Since all directors' meetings must take place outside the United States, an FSC may wish to adopt bylaws that prohibit U.S. directors' meetings and fail to recognize as meetings any discussions held by U.S. directors who inadvertently discuss FSC business in the United States.

Other FSC qualification rules limit to 25 the permissible

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6. I.R.C., Sec. 992.
7. I.R.C., Sections 922 (a)(1)(A)(i) and 927 (e)(3).
8. See "FSCs: Virgin Islands, Guam are Likely Targets as Corporations Await Treasury Department's List," *BNA Daily Tax Report*, 30 August 1984, at LL-1.
9. I.R.C., Sec. 922 (a)(1)(D)(i).
10. Senate Committee Report (Tax Reform Act of 1984 – P.L. No. 98-369, 7/18/84) Foreign Sales Corporations Generally.
11. See U.S. Draft Model Income Tax Convention (June 16, 1981), Article 5, Paragraph 6.
12. See *International Tax Treaties Services*, Commentary on Article 5, of the O.E.C.D. Model Income Tax Treaty.
13. Virgin Islands Code, Proposed Amendment to Title 33, Subtitle 4 – Foreign Sales Corporations.
14. Id Section 4009.
15. Id Section 4008.

number of FSC shareholders,[16] prohibit the FSC from issuing preferred stock[17] and forbid a controlled group of corporations from including an FSC and either one of the new legislation's export vehicles for smaller exporters (discussed below).[18] Furthermore, a corporation seeking the FSC tax exemption must make a valid FSC election. The legislative history suggests a newly formed FSC can properly elect FSC status within its first 90 days of existence.

The FSC foreign presence test also requires that the company be managed outside the United States. This is deemed to occur if: all shareholder and directors' meetings are held overseas, the FSC's principal bank account is located outside the United States, and all dividends, legal and accounting fees, officers' salaries and directors' fees are disbursed from a foreign bank account.[19] With the possible exception of the first requirement, these rules should not cause serious problems for most U.S. exporters. If future IRS regulations and the foreign corporate laws where the FSC is incorporated tolerate the use of proxies at shareholders' and directors' meetings, exporters may find even the first requirement manageable.

The FSC advantage is available only if certain economic activities are performed outside the United States by the FSC or its contracted agent.[20] To this end, the legislation focuses on two categories of activities associated with each export transaction: the sales activities, and specified economic functions creating direct costs of an export sale.[21]

Each export transaction or group of transactions must have foreign participation by the FSC or its agent in the solicitation, negotiation or making of the contract.[22] This will require the FSC or its agent to have the authority and capability to communicate information from outside the United States to the foreign customer. The foreign sales activities requirement may prove to be the most troublesome for FSCs because the participation is considered foreign only if the communication originates overseas. Although the FSC can fulfill this requirement in various ways, including communicating the terms of sale, of an offer, or the acceptance of an offer; it is unclear whether this would be considered foreign participation if the FSC is merely relaying a communication which, in fact, originates in the United States from its related supplier. To the extent an FSC has a more substantial role in these activities, exporters may suffer from the practical problems and costs associated with a distant office's capacity to promptly communicate essential sales information. Therefore, it is vital that exporters carefully consider the character and extent of the FSC's participation in the sales activities of export transactions. In cases where the U.S. exporter currently solicits export orders through foreign sales agents or representatives, it may be practical to have the FSC contract with such foreign sales entities for such functions to be performed on behalf of the FSC.

In addition to the foreign sales activities, the FSC or its agent must also perform outside of the United States certain activities that generate the direct costs associated with each export transaction.[23] Specifically, foreign activities must produce 50% of the total direct costs attributable to the following functions, or 85% of the direct costs of each of any two of them: advertising and sales promotion, processing orders and arranging for delivery, transportation (freight costs), customer billing and collection, and assumption of credit risks. An exporter's current business practices and methods of operation will determine the severity of this rule. For instance, in the past, for reasons as practical as the availability of computer facilities and competent clerical help, exporters have typically performed the order processing, billing and collection activities in the United States. Given these practical constraints, most exporters will find it easier to meet the 85% requirement by choosing two less "active" activities. Furthermore, some of the sting of these rules is eliminated by the fact that these percentage tests can be applied on a transaction by transaction basis or by grouping transactions by broad product categories,[24] giving an exporter the flexibility to choose which test should be applied for each transaction.

Assuming the FSC meets the foreign presence and foreign economic processes requirements, certain receipts from export transactions will be characterized as "Foreign Trading Gross Receipts" (FTGR) from which the FSC tax exemption is ultimately derived. With only few exceptions, the types of export receipts that qualified for DISC benefits will qualify for the FSC exemption – a parallel evidenced by the Committee Report's reference to the DISC regulations for determining which export transactions qualify as FTGR.[25] An FSC's FTGR do not include its investment income and carrying charges,[26] causing this income to be ineligible for the tax exemption; however, receiving this income will not disqualify the corporation from FSC benefits on other income, nor jeopardize its status as it might under the DISC provisions. For reasons discussed in more detail below, most FSCs will want to avoid receiving any investment income.

An FSC must determine the foreign trading income (FTI) it is entitled to earn from the entire FTGR. An FSC has a number of available methods for determining the amount of its FTI. If the export transaction arises from the FSC's dealings with an unrelated supplier, its amount of FTI is determined according to the actual arm's-length price. In the more typical situation, however, the FSC will act as a "buy-sell" entity commission agent for a related export supplier. If it is acting in either of these capacities, the income of the FSC ostensibly must be calculated by employing the arm's-length pricing standards or one of the two "administrative pricing rules" set forth in the FSC legislation. Under the administrative pricing rules, the export transfer price for

16. I.R.C., Sec. 922 (a)(1)(B).
17. I.R.C., Sec. 922 (a)(1)(C).
18. I.R.C., Sec. 922 (a)(1)(F).
19. I.R.C., Sections 924 (b)(1)(A), 924 (c)(1), 924 (c)(2), 924 (c)(3).
20. I.R.C., Sec. 924 (d).
21. Senate Committee Report (Tax Reform Act of 1984-P.L. No. 98-369, 7/18/84) Foreign Economic Processes.
22. I.R.C., Sec. 924 (d)(1)(A),
23. I.R.C., Sections 924 (d)(1)(B), 924 (d)(2) and 924 (e).
24. Senate Committee Report (Tax Reform Act of 1984–P.L. No. 98-369, 7/18/84) Direct Cost Tests.
25. Id, Foreign Trading Gross Receipts.
26. I.R.C., Sec. 924 (f)(2).

each transaction or group of transactions is limited to an amount that would allow the FSC to derive taxable income from the transaction which does not exceed the greater of:

- 23% of the FSC's and related person's combined taxable income (CTI) attributable to the export transaction(s), or
- 1.83% of the foreign trading gross receipts derived from the transaction by the FSC, limited to 46% of CTI.[27]

There is little doubt that the vast majority of exporters will prefer to use these administrative transfer pricing rules. However, they may be used only if the FSC or its agent perform (in the United States or outside the United States) *all* of the economic processes associated with the transaction. To the extent that some of the economic activities are to be performed by an entity related to the FSC, care should be taken to ensure that a valid contractual relationship exists between the parties.

The portion of the FSC's foreign trade income that is exempt from U.S. Federal tax (referred to as "exempt foreign trading income", or EFTI) depends on whether the FSC's shareholders are corporate or noncorporate, and whether or not the FTI is computed under the administrative pricing rules. The EFTI is exempt from tax because it is considered to be foreign source income not effectively connected with a U.S. trade or business. The remaining FTI is taxed at the FSC level even though it may be foreign source income earned by a foreign corporation. For FSCs using true arm's-length transfer pricing rules, 30% of FTI is considered EFTI if the FSC has corporate shareholders; for FSCs with noncorporate shareholders, the exempt portion of its FTI is 32% of the total. See Exhibit 1.

The FSC's deductions relating to each export transaction or group of transactions are allocated to the FTI ratably between the exempt and nonexempt portions of FTI.[28] The tax credits usually available to corporations are not available to FSCs.[29] An FSC can claim foreign tax credits, however, for foreign taxes paid on its investment income and carrying charges and on the taxable portion of its FTI if it is computed under the arm's-length pricing method.

Unlike their DISC predecessors, FSCs are not required or deemed to distribute earnings to their shareholders.[30] When distributions are made by the FSC, they are considered to be first out of the earnings and profits attributable to the FSC's foreign trading income and then out of other income of the FSC.[31] The taxability of FSC distributions depends on the type of shareholder receiving them. Distributions from exempt and nonexempt FTI made to corporate shareholders of an FSC are nontaxable since corporations are granted a special 100% dividends-received deduction.[32] Distributions attributable to the other income of the FSC, including investment income and carrying charges, are generally taxable to the corporate shareholder under the usual tax rules. Because an FSC's investment income is subject to U.S. taxation at both the FSC level and, via dividends, at the shareholder level, FSCs should avoid generating investment income. Typically, an FSC would be expected to immediately distribute all its cash (other than a modest level of working capital) to its U.S. parent. Because individual shareholders are not eligible for the 100% dividends-received deduction, all FSC distributions to them are taxed as ordinary dividends. The FSC distribution rules obviously favor corporate shareholders – an important consideration for individuals currently owning DISCs.

Under some circumstances, the export incentive provided by FSCs will come at too high a price, particularly to exporters who are in a net operating loss position. As foreign corporations, the income of an FSC cannot be included in a consolidated return.[33] Consequently, even if its related supplier has net operating losses, the FSC would have to pay tax on a portion of its income. Under the transfer pricing rules, the income allocated to the FSC would serve to increase the supplier's net operating loss carryovers. However, this would occur at the expense of current FSC taxes. Smaller exporters may also find the FSC foreign presence and economic processes requirements particularly costly and frustrating. Recognizing the prohibitive administrative costs associated with these requirements, the legislation includes two export incentive provisions for smaller exporters: the "small FSC" and the "interest-charge DISC".

Although they still must meet the foreign presence rules, an FSC that elects to be treated as a "small FSC" is exempt from the foreign management and economic processes requirements.[34] The advantage of reduced administrative costs is offset by the limitation of small FSC rules to FTGR not in excess of $ 5 million per year. The small FSC rules do provide, however, some flexibility in deciding which gross receipts fall within the $ 5 million limitation.[35] This should allow small FSCs to maximize exempt income by allocating high profit margin receipts to the limitation . If the small FSC desires to use the administrative pricing rules, it or its agent must still perform (in the United States or outside the United States) all of the economic processes associated with the transaction. However, since a small FSC can arrange to have its parent perform these activities for the FSC within the United States, this requirement seems to be more window dressing in nature, than substance.

For exporters whose export receipts exceed the small FSC $ 5 million limitation, the "interest-charge DISC" may be preferable as an export vehicle. With the exception of the DISC "incremental rule", the interest-charge DISC is governed by most of the tax rules applicable to DISCs, including the gross assets and receipts tests. Exporters using an interest-charge DISC will be able to

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27. I.R.C., Sec. 925 (a).
28. I.R.C., Sec. 921 (b).
29. I.R.C., Sec. 921 (c).
30. Senate Committee Report (Tax Reform Act of 1984 – P.L. No. 98-369, 7/18/84). Distributions to Shareholders.
31. I.R.C., Sec. 926 (a).
32. Tax Reform Act of 1984, Sec. 801 (b)(1) amending I.R.C., Sec. 245 (c)(1).
33. I.R.C., Sec. 1504 (b)(3).
34. I.R.C., Sec. 924 (b)(2)(A).
35. Senate Committee Report (Tax Reform Act of 1984 – P.L. No. 98-369, 7/18/84). Small FSC.

defer income taxes on export receipts up to $ 10 million.[36] DISC shareholders will have to pay an interest charge based on Treasury bill rates imposed on the amount of DISC tax deferral.[37] Therefore, in effect, an interest-charge DISC will be borrowing the amount of the DISC tax deferral from the U.S. Treasury at a relatively low cost. Noncorporate exporters may find interest-charge DISCs attractive since these exporters would be denied the benefit of the special 100% dividends-received deduction on FSC distributions.

CONCLUSION

There is little doubt that certain provisions of the FSC legislation will cause suspicion and alarm on the part of some GATT members, particularly those provisions aimed at legitimizing a nominal foreign presence and forgiving the deferred taxes on the accumulated income of existing DISCs. Since years of protests and debate over DISC culminated in the adoption of these FSC provisions, GATT members may decide that further protests would not only be futile, but would divert their resources from other pressing trade issues.

Exporters will find many questions left unanswered by the new legislation. Answers to such broad issues as which countries are eligible for the incorporation of an FSC, the mechanics for operating an FSC, and rules for a commission FSC will remain unclear until the Treasury issues FSC regulations. The Congress has indicated in its legislative committee explanations that such regulations should be designed to liberally apply the statute so as to foster the overall policy objectives of export promotion. Nevertheless, with the 1 January 1985 effective date of the FSC provisions, exporters have little time to waste in implementing this unique Congressional invention – the Foreign Sales Corporation.

36. Tax Reform Act of 1984, Section 802 (b)(1) amending I.R.C., Sec. 995 (b)(1)(E).
37. Tax Reform Act of 1984, Section 802 (a)(3) adding I.R.C., Sec. 955 (f).

Additional information regarding Foreign Sales Corporations may be found in the Deloitte Haskins & Sells booklet, "The Foreign Sales Corporation Provisions." The booklet may be obtained by writing to Mr. Eugene S. Linett, National Tax Editor, Deloitte Haskins & Sells, 1114 Avenue of the Americas, New York 10036.

Exhibit 1

The following description of the pricing rules is illustrated in Exhibit 1. In the illustration, the FSC has $ 10,000 of FTGR. Total attributable costs of the FSC and its supplier equal $ 9,000. Therefore, combined taxable income (CTI), before reduction by the exempt amount, equals $ 1,000. It is assumed that the FSC has a corporate shareholder.

1. 23% of CTI. The allowable income to the FSC is 23% of CTI, or $ 230. Of this amount, 15/23rds, or $ 150, is exempt from U.S. taxation. (The exempt amount would be 16/23rds if the FSC has a noncorporate shareholder.)
2. 1.83% of FTGR. The allowable income to the FSC is 1.83% of total FTGR, or $ 183. Of this amount, 15/23rds, or $ 119, is exempt from U.S. taxation. (The exempt amount would be 16/23rds if the FSC has a noncorporate shareholder.) The limitation of $ 460 (46% of $ 1000) under this method does not apply in this case.

	...FSC	Rules....
	23% of *CTI*	1.83% of *FTGR*
A. CTI	$ 1,000	$ 1,000
B. Allowable income to FSC	230	183
C. Tax on supplier's income ((A) – (B)) x 46%	354	376
D. Exempt amount 15/23 x (B)	150	119
E. Tax incurred by FSC ((B) – (D)) x 46%	37	29
Total U.S. tax (C) + (E)	$ 391	$ 405

For comparison, the tax at 46% on $ 1,000 without regard to FSC rules would be $ 460.

Exhibit 2

Comparison of FSC – DISC characteristics

	FSC	DISC
Where incorporated:	Qualified foreign country or U.S. possession	United States
Foreign presence required?	Yes	No
Where managed:	Outside the United States	United States
Benefits tied to incremental export sales?	No	Yes
Owned by:	Most advantageous for U.S. corporation	Any shareholder
Character of tax incentive:	Partial exemption	Tax deferral
Pays U.S. income taxes?	Yes	No
Deemed distributions to shareholders	No	Yes
Distributions taxable to shareholders?	Usually, no	Yes
Exist as a paper entity?	No	Yes
Must tax year be same as parent's?	Yes	No (producing additional tax deferred)
Safe haven transfer pricing rules provided?	Yes	Yes
Nonresident director required?	Yes	No
Qualified assets and gross receipts test applied?	No	Yes

JAMAICA:

Pay-As-You-Earn Taxation

By D.A.C. Boyd

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Introduction

The Pay-As-You-Earn (PAYE) tax is an important component of the taxation system for almost all countries. It frequently accounts for in excess of 20% of total tax revenues. Its importance is also indicated by the fact that it is levied on virtually the entire labour force of the country.

This paper examines PAYE taxation policy in Jamaica, looking in some detail at the major PAYE tax reforms introduced in 1977. It examines the impact of inflation and assesses the relative burden of this form of income tax collection on earned labour incomes in Jamaica. It looks at the distributional, allocational and macro-economic fiscal effects, and comments on the question of revising the system. The last section pulls together the main conclusions of the paper.

The tax credit reforms of 1977

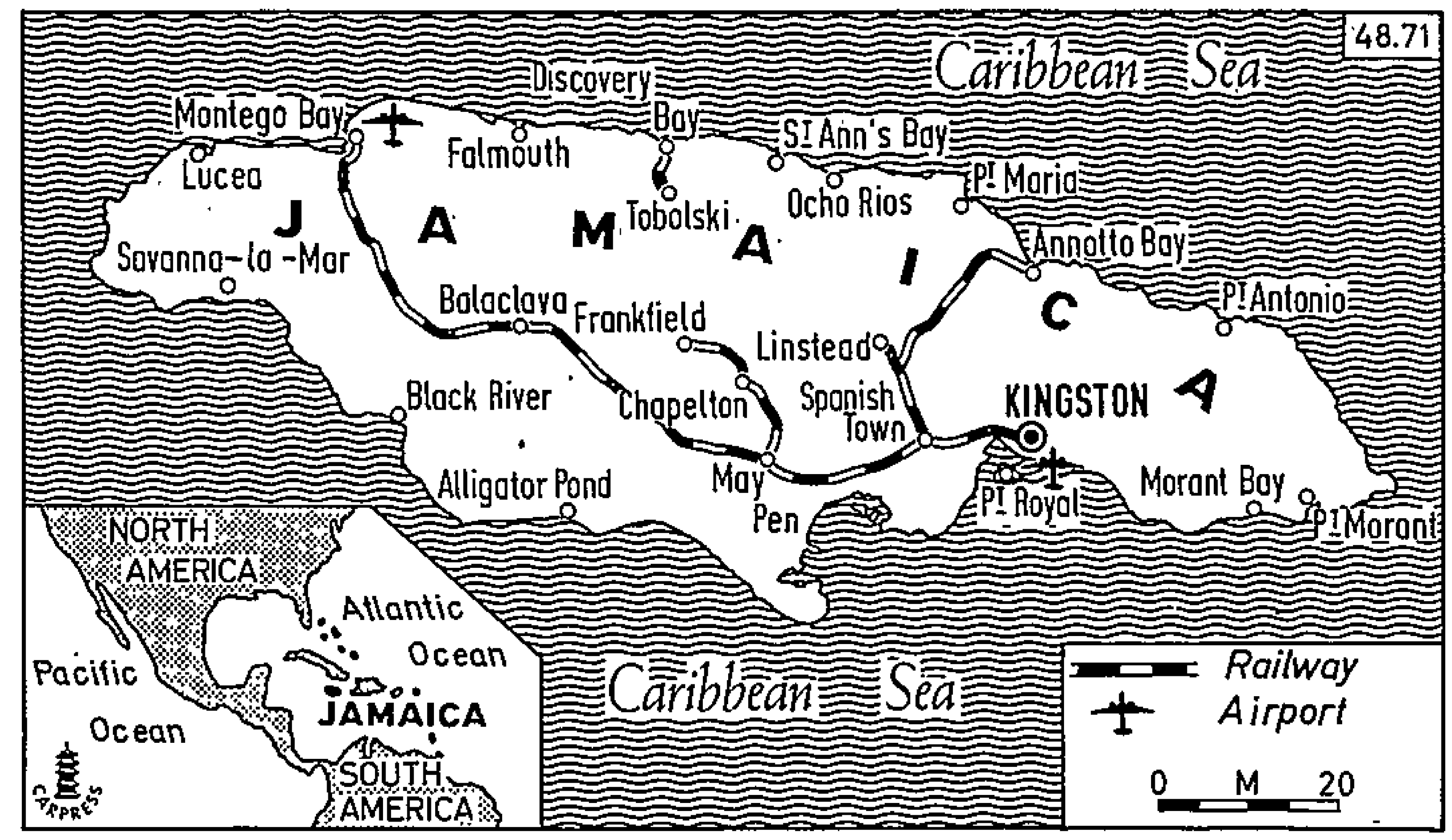
The PAYE Tax Credit System (TCS), which became effective on 1 January 1977, replaced the Income Allowance System (IAS), which was adopted from Britain in 1954, when the PAYE tax was introduced in Jamaica. The introduction of the TCS and the restructuring of the rates of personal income tax and the income bands to which they apply was to be the first phase in a programme of direct taxation reform.

Under the IAS, PAYE taxpayers were given allowances in the form of untaxed income. These were known as income allowances. For example, an income allowance of $1,500 meant that no tax would be deducted on $1,500 of the taxpayer's yearly income. Under the IAS the tax was levied against chargeable income, where:

chargeable income = gross income – income allowances.

The total tax liability would then be determined by the tax rates applicable to the different income bands.

Under the TCS, tax is levied on all of the income, and tax credits are given against the tax liable for payment. Under this system, the total tax liability is also determined by the marginal tax rates levied on various income



bands, but the tax is levied against statutory income, where:

Statutory income = gross income – national insurance scheme contributions,

in the case of Jamaica.

The TCS is generally regarded as more equitable than the IAS. Under the TCS the dollar value of the tax credit is the same for all PAYE taxpayers, whilst under the IAS the dollar value of the tax credit is greater for taxpayers on higher incomes than for those on lower incomes. Indeed, this aspect of equitability between the tax systems is the only reason given for changing the system. As the then Minister of Finance explained.

> Under the existing provisions of the Income Tax Act, personal allowances are established as a given dollar deduction from income. The result of this system is that the dollar tax saving is greater at higher income levels than at lower levels. If, however, personal allowances are given in the form of tax credits against tax payable on statutory income, the tax saving will be the same in dollar terms regardless of the income level of the taxpayer.
> (Ministry Paper 54, Ministry of Finance, 1976, p. 1)

It is the general case, and it is true of Jamaica, that tax credits cannot usually be claimed in cash. In order to claim a sum of tax credit in cash that sum would have to have been paid by the taxpayer in the first place. The credits, in effect, can only be used to reduce tax liabilities. It essentially means that, if a person's tax credit is $600 and the tax liability on his income is $1,000, then only $400 is actually due for payment.

Although the administration of the two systems is quite different, requiring different tax tables and operational methods, in the case of Jamaica there seems to be no significant advantage to be gained through the implementation of either system. From the theoretical standpoint, the main difference between the TCS and the IAS is the marginal equitability that is to be gained from the TCS which should result in a slightly improved progressive redistribution of the tax burden. This redistribution is hardly likely to be noticeable in most well-administered tax systems. In Jamaica certain salient features of the PAYE tax administration, such as the absence of inflationary adjustments, have totally overwhelmed this redistributive impact. The general implication seems therefore to be that a change from one system to the other is unlikely to have any significant distributional or allocational effect.

The 1977 switch to the TCS was accompanied by a restructuring of tax rates. Pre-1977 the PAYE tax structure consisted of 8 rates ranging from 20% to 60%. In 1977 the 8-rate structure remained, but the rates now ranged from 30% to 80%. Accompanying the increase in tax rates was an increase in the income level to which the rates applied – see Table 1 for a summary of these structures. From all reports these tax reforms were not resisted seemingly for one very good reason; they meant an across-the-board reduction in tax liabilities for all PAYE taxpayers. Gross PAYE collections fell 11.4% between fiscal years 1976/77 and 1977/78.

TABLE 1

Schedule of rates effective 1 January 1980
(year of assessment 1980)

Still effective January 1984

On the statutory income of every individual:

First $	7,000 at 30%	$ 2,100
Next	3,000 at 40%	1,200
	10,000	3,300
Next	2,000 at 45%	900
	12,000	4,200
Next	2,000 at 50%	1,000
	$ 14,000	$ 5,200

Over $ 14,000 at 57.5%

Schedule of rates effective 1 January 1977
(years of assessment 1977, 1978, 1979)

On the statutory income of every individual:

First $	5,000 at 30%	$ 1,500
Next	2,000 at 35%	700
	7,000	2,200
Next	3,000 at 40%	1,200
	10,000	3,400
Next	2,000 at 45%	900
	12,000	4,300
Next	2,000 at 57.5%	1,150
	14,000	5,450
Next	6,000 at 60%	3,600
	20,000	9,050
Next	10,000 at 70%*	7,000
	$ 30,000	$ 16,050

Over $ 30,000 at 80%*

**Note re computation of tax for Y/A 1977*
Because of the late implementation of the 1977 Amendment Act, calculations for the 1977 Y/A are on the basis of 70% and 80% *of 50% of the excess* over $ 20,000 and $ 30,000 respectively.

Schedule of rates effective 1 January 1975
(years of assessment 1975 and 1976)

On the chargeable income of every individual:

First $	1,000 at 20%	$ 200
Next	1,000 at 25%	250
	2,000	450
Next	1,500 at 30%	450
	3,500	900
Next	2,000 at 35%	700
	5,500	1,600
Next	2,000 at 42.5%	850
	7,500	2,450
Next	2,000 at 50%	1,000
	9,500	3,450
Next	3,000 at 57.5%	1,725
	$ 12,500	$ 5,175

Over $ 12,500 at 60%

For the 1976 Y/A, where the chargeable income exceeds $ 8,500 p.a., add a surtax of 10% for 9 months, that is effectively 7.5% for one year (subject to marginal relief in an appropriate case.)

Note: The official exchange rate is J$ 1.78 = US$ 1.00.

It appears that the new levels of the credits were achieved by a simple method. The impact of a tax credit on income can of course be expressed in terms of an income allowance at a certain basic tax rate. For instance, at a basic tax rate of 30%, the personal tax credit of $600 p.a. is equivalent to an income allowance of $2,000. This is so since the tax liability on $2,000 at 30% is $600.

The basic tax rate introduced along with the TCS was set at 30% and if this rate is used to express the tax credits in terms of income allowances we find that all allowances were increased by precisely 33.33% except in 3 cases. The pension allowance was increased by 166.67% and the life insurance and capital growth allowances were both increased by 100%.

Why was there an across-the-board increase of 33.33% in allowances? Over the 2 years since the last PAYE inflationary adjustment in 1975, the All-Jamaica Consumer Price Index reports a 21% increase. Therefore, a 21% increase was all that was necessary to bring the real value of allowances to their 1975 levels. Two possible reasons can be offered. The first is that the Government sought to increase real tax allowances in 1977. However, given the substantial growth in the budget deficit over this period this seems most unlikely. The second and more likely reason is that the Government could afford to be generous in this respect because the TCS and the increased marginal tax rates would increase PAYE revenues at a fast rate in a period of inflation. In fact, over the 1975-79 period, total taxable emoluments rose by 13.5%, but the total PAYE tax deducted rose by 32%! This increased tax haul occurred at a time when real incomes were undergoing massive reductions. The All-Jamaica Consumer Price Index increased by no less than 147% over the same period.

The 1977 PAYE tax reforms had two stated objectives: (i) increased equitability of the system; and (ii) increased incentives for saving. The first objective was to be achieved through the change from the IAS to the TCS, and the second by increasing tax benefits associated with savings in building societies, life insurance and capital growth schemes. The implication of the reforms for the first objective has been entirely unnoticeable in any real way. Indeed, it would be fair to say that the change in the administration of the PAYE per se has achieved nothing that could not have been achieved under the old IAS and the resource cost of the change would have been avoided. We shall discuss the implication for the second objective in the following sections.

Tax credits and inflation

The levying of a direct tax, such as the PAYE, during a period of inflation can bring about special problems and it is within this context that the Meade Committee wrote that *a reasonable tax structure must be considered in real terms and not in monetary terms*, and this implies adjustment of the monetary base (James Meade 1977, p. 99).

Jamaica, along with most countries in the West, experienced high rates of inflation during the 1970s which have continued into the 1980s. Table 2 shows the level of the All-Jamaica Consumer Price Index between 1975 and 1982. The steep rise in the CPI suggests that by November 1982 the tax credits had lost two thirds of their real value.

Table 2
All-Jamaica Consumer Price Index
1 January 1975 = 100

Year	Index
1975	111.8
1976	120.9
1977	137.9
1978	206.0
1979	246.7
1980	317.3
1981	332.7
1982	356.2*

* Figure relates to November 1982. Other figures are for December of the year.

Source: Department of Statistics, Consumer Price Indices Annual Review 1980.

It is noteworthy that the level of tax credits which exists nearly 6 years after their introduction is in monetary terms virtually the same as when they were first introduced on 1 January 1977. Column (a) in Table 3 shows the monetary value of the various tax credits introduced on 1 January 1977. In all but two cases these monetary values have remained the same since that time.[1] Column (b) shows the real value of the tax credits deflated by the All-Jamaica CPI for November 1982.

It is clear from Table 3 that the tax credits have lost most of their real value and consequently the level of credits required to maintain the 1977 levels is quite high. This loss of real value to the taxpayer is of course directly related to a gain in PAYE tax revenue to the Government. The non-adjustment of the tax credits has meant that the tax burden on real income has increased. In essence, therefore, fiscal drag has been a significant feature of PAYE taxation in Jamaica over the last 6 years and it is

Table 3
The impact of inflation on tax credits*
(J$)

Tax credit	Real value of tax credits 1 Jan. 1977 (a)	Real value of tax credits 1 Dec. 1982 (b)	Money value required to maintain Jan. 1977 real value (c)
Personal allowance	600	204	1768
Pension allowance	400	136	1179
Wife allowance	140	48	413
Wife earned income allowance	320	109	943
Child allowance	80 (100)**	27 (34)	236
Child at university	120	41	354
Relative guardian allowance	40	14	118
Dependent relative	40	14	118
Maintenance	160	54	471
Life insurance	360	122	1061
Capital growth	360	122	1061
Medical expenses	40	14	118
Mortgage interest	60	20	177
Household help	208	71	613
Building society	360	122	1061
Special tax credit for income under \$11,000 (\$12,000)**	104 (156)**	35 (53)	306

* *Note:* The real value of the tax credits where the credit amount has remained unchanged is approximately 34% of the original 1977 value when deflated by the All-Jamaica Consumer Price Index.

** Figures in brackets are the monetary values of the allowances effective from Jan. 1980.

reasonable to expect this to have contributed to hardship, especially among low paid workers.

A part of the reforms introduced in 1977 aimed at encouraging personal savings but these measures have lost much of their effectiveness due to the erosion of the tax credit incentives by inflation. In order to encourage personal savings a tax credit up to a maximum of \$360 per annum was given with respect to certain categories of savings. Taxpayers can obtain tax credits by saving in the following areas: through purchases of units in the Jamaica Investment (Capital Growth) Fund; life insurance and deferred annuities; and shares in building societies and registered cooperative societies. The conditions are such that \$600 saved in each of these qualifying ways entitles taxpayers to \$360 in tax credit, so that it was possible for a taxpayer to obtain from this source a maximum tax credit of $3 \times \$360 = \$1{,}080$ per annum. In fact, this is the source of most tax credits under the present structure. Compare, for example, the maximum saving incentive of \$1,080 against the personal allowance of \$600 or wife allowance of \$140. The absence of inflationary adjustments has meant that these measures have lost much of their effectiveness in providing either a loanable source of savings or incentives to save.

1. Effective from 1 January 1980, child allowance increased from \$ 80 to \$ 100, and the special tax credit allowance was increased from \$ 104 to \$156. The threshold level for the Special Tax Credit was also increased from \$ 11,000 to \$12,000. In order to maintain the real 1977 level the increase required is to \$ 32,409.

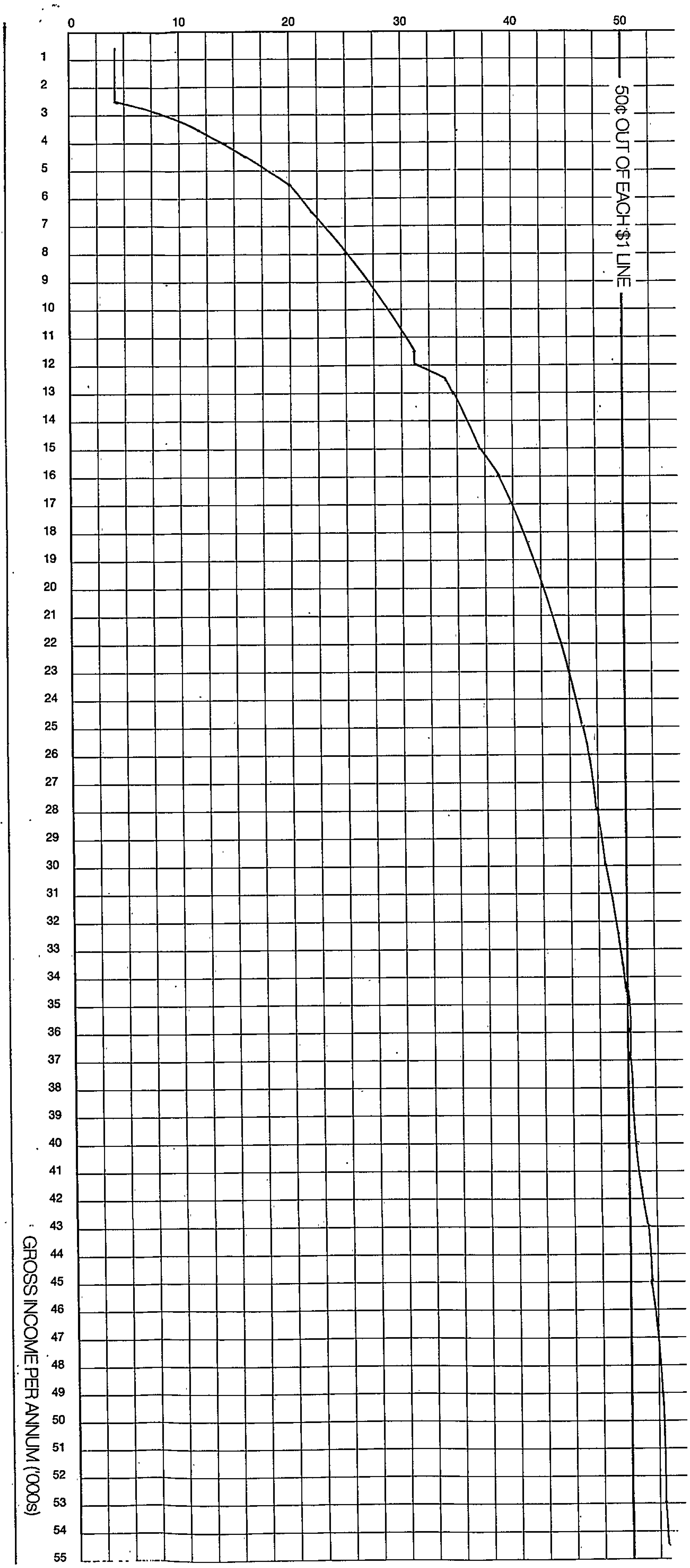


Figure 1

EFFECTIVE RATES OF TOTAL DEDUCTION FOR 1982

PROFILE OF TAXPAYER: SINGLE PERSON

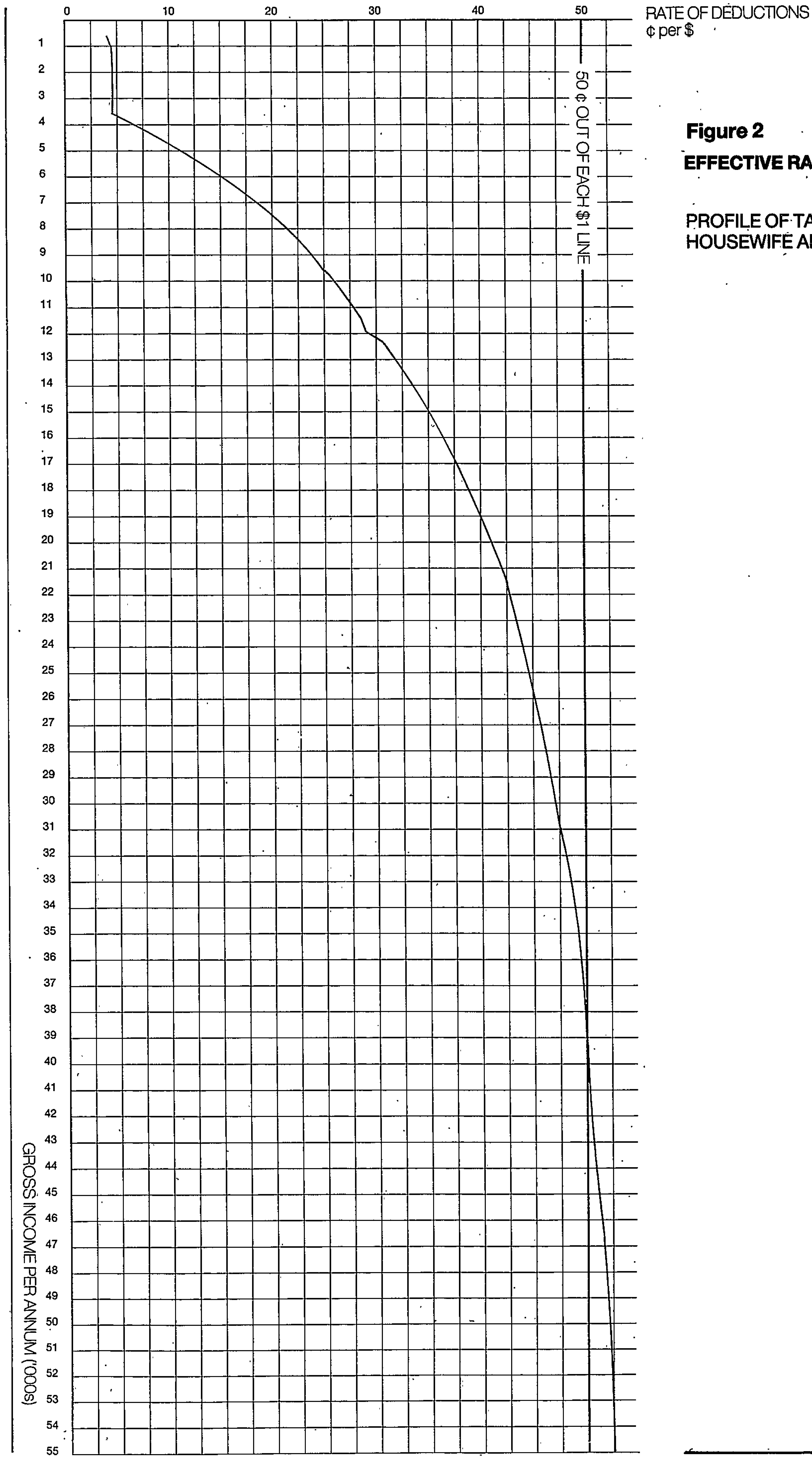


Figure 2

EFFECTIVE RATES OF TOTAL DEDUCTION FOR 1982

PROFILE OF TAXPAYER: MARRIED MAN WITH HOUSEWIFE AND TWO CHILDREN

How high is personal income tax

On the whole, the evidence suggests that personal income tax in Jamaica is very high in comparison with other countries. This is demonstrable by looking at the top marginal tax rate and the level of income to which it applies across a few countries. The top marginal tax rate on earned income in the U.K. is 60%, which is reached at US$ 57,712[2] for a married couple. In Australia, the top rate is 60% which is payable on incomes in excess of US$ 39,630.[3] In Trinidad and Tobago, the top rate is 70% which applies to taxable income between US$ 25,000[4] and US$ 33,333. If taxable income exceeds US$ 33,333, the total amount of taxable income is taxed at the rate of 50%. In Thailand, the top rate is 65% on incomes exceeding US$ 47,619.[5] In Hong Kong, the top rate is 15% which is reached at US$ 29,227[6] for a married person and US$ 19,110 for a single person.

Now, although there are some problems in making these inter-country comparisons, it is clear that in all the cases quoted above the burden of income tax is quite considerably less than the Jamaican income tax, where the top marginal rate of 57.5% is levied on incomes in excess of US$ 7,875[7] per annum. Thus, whilst Jamaica does not have the highest marginal tax rate, the top Jamaican rate is levied on extremely low incomes.

In fact, the overal structure of Jamaican personal income tax is quite burdensome on relatively low income. Figures 1 and 2 show the number of cents per dollar that is deducted from incomes ranging from $500 to $55,000 per annum for two different PAYE taxpayer profiles. Figure 1 relates to a single person claiming only the single person allowance; and Figure 2 relates to a married man claiming the married man's allowance, wife allowance and an allowance for two children. The steep slopes at the low income ranges indicate a very rapid increase in the effective rate of tax.

Thus, whilst the highest income tax rate at 57.5% is comparable with those of other countries, the unfortunate feature of the Jamaican case is that this rate is levied on relatively low incomes. In Jamaica all personal incomes exceeding J$14,000 per annum are taxed at this rate. In order to put this income in perspective, we may note that this income is likely to be exceeded by many university graduates upon starting their first job on leaving university. A trained office secretary of one or two years' experience may also be reasonably expected to earn such an income.

An anomaly with respect to the Special Tax Credits (STC) is worth noting here. The STC is given on all incomes not exceeding J$ 12,000. Yet, only J$ 2,000 further on, an income of J$ 14,001 attracts the highest marginal tax rate. In the space of a modest increase of J$ 2,000 per annum, the taxpayer loses the STC and faces an increase in the marginal tax rate of 12.5% points to a rate of 57.5%. This anomaly obviously contributes to the voraciousness of the tax.

2. The rate of exchange: US$ 1 = 0.5180
3. The rate of exchange: US$ 1 = A$ 0.87
4. The rate of exchange: US$ 1 = TT$ 2.40
5. The rate of exchange: US$ 1 = B[ht] 21.00
6. The rate of exchange: US$ 1 = HK$ 5.56
7. The rate of exchange: US$ 1 = J$ 1.78

THE EFFECTS OF PAYE TAXATION IN JAMAICA

The structure and administration of PAYE have important effects on the behaviour of the economy. It is often difficult to separate the different effects because one effect generally leads to another. For example, tax policy may effect a change in the distribution of income and this may lead to a reallocation of workers' time between leisure and work, which may well affect the structure of prices, demand and supply in the economy, thus changing the allocation of resources. Whilst recognising that a certain degree of interdependency exists we shall summarise the effect of PAYE taxation in Jamaica in three main groups: distributional effects, allocational effects, and macroeconomic fiscal effects.

(a) Distributional effects

Distributional effects are generated by the impact of the tax on the distribution of income. They describe the way in which tax policy affects real incomes. It is generally desirable that a country's policy on the taxation of labour income should be progressive and the Jamaican PAYE tax is structured to achieve this. A tax is usually defined as progressive if the proportion of the individual's income which is paid increases as his or her income increases, so that high income earners pay relatively more than the low earners. Figures 1 and 2 demonstrate this to be the case in Jamaica. The average rate of deduction can be seen to increase as income increases.

In a period of inflation, a progressive tax structure will result in fiscal drag if the tax credits or income allowances are not increased to take into account increases in the general level of prices. Since in almost all instances the level of tax credits has remained unchanged since they were introduced in January 1977, fiscal drag has been a salient feature in the economy. The rate of taxation across the entire real income distribution has increased. Levels of real income which previously were not liable to tax have been increasingly drawn into the tax net. These will, inter alia, inevitably lead to increased poverty and hardship amongst workers.

Furthermore, although the PAYE structure is progressive, there is a rapid increase in the average rate of deductions which in effect reduces the progressivity of the tax. The revealed distributional effect therefore is the continued reduction in real net incomes as inflation erodes the purchasing power of money incomes and increasing real tax liabilities.

(b) Allocational effects

Allocational effects depend upon the ways in which tax policy affects the allocation of resources and forms a part of micro-economic decisions about labour and non-labour resource allocation. In general, distributional effects will lead to allocational effects and this is demonstrable in the case of Jamaica.

The effect of the reduction in real net incomes described above will lead to people reconsidering the allocation of their labour resource, i.e. their work effort. They can decide to:

(i) increase work effort and decrease leisure in an attempt to maintain living standards – that is usually defined as the "income effect";

(ii) decrease work effort and increase leisure – this is usually defined as the "substitution effect"; or

(iii) leave the allocation as is, with the implication that real income will fall.

The outcome of these decisions will affect the overall behaviour and perhaps indeed the structure of the economy.

In Jamaica certain allocational effects are discernible though sometimes difficult to demonstrate empirically. In the absence of social security payments and welfare benefits there is likely to be a significant income effect especially given the relatively large number of low paid workers and low level of real incomes. However, the character of the income effect is not a straightforward increase in labour hours. The evidence suggests that economic effort is increased in areas where income rewards are not easily taxed, although it may be legally subject to tax. Economic effort is likely to be increased in what is known as the shadow economy or the informal and unincorporated sector. The evidence clearly points to the taking on of work on the side, and higglering – small scale buying and selling of both foreign and domestic manufactured and agricultural goods – as popular areas for increased labour effort.

These allocation changes are bound to affect the structure of economic activity and as such have implications about growth and long term development. For example, in Jamaica such allocations favour unincorporated business ventures and shadow activity. Now whilst these ventures may provide the best opportunity for the maximisation of income, they may not provide the best long term growth and development opportunities. Thus, it may be argued that the tax policy is likely to militate against the optimum allocation of labour and non-labour resources, especially if it can be seen to allocate resources away from the manufacturing sector.

An important objective of the 1977 PAYE reform was to increase the rate of savings. The evidence suggests, however, that the overall effect of the PAYE tax has been to reinforce the high rate of consumption and low savings rate that has characterised the Jamaican economy since the mid 1970s. Table 4 shows the average propensity to consume over the 1969 to 1981 period. The combination of the high rate of deduction and inflation has eroded the real value of tax credit incentives for savings, and has increased demand for fringe benefits and payments in kind. Indeed, these latter have become a standard feature of the reward structure from the lowest paid workers to the highest.

(c) Macro-economic fiscal effects

In the most immediate and obvious way, the structure of the PAYE tax is an important mechanism providing the Government with the revenue necessary for the management of the economy. PAYE collections accounted for approximately 25% of total tax revenues in 1981/82, and accounted for 16% of total recurrent expenditure. These high proportions indicate the considerable importance of PAYE tax on Government finance.

Table 4
Jamaican average propensity to consume, 1969-81
(J$M)

Year	Final consumption expenditure	National disposable income	Average propensity to consume*
1969	714.8	883.4	0.81
1970	853.7	1,045.5	0.82
1971	967.4	1,126.2	0.86
1972	1,144.3	1,308.2	0.88
1973	1,350.7	1,576.8	0.86
1974	1,748.9	2,021.6	0.87
1975	2,193.7	2,378.6	0.92
1976	2,514.3	2,447.0	1.03
1977	2,672.6	2,629.4	1.02
1978	3,145.0	3,239.5	0.97
1979	3,555.2	3,775.6	0.94
1980	4,122.3	4,158.3	0.99
1981	4,713.3	4,728.4	1.00

$$* \text{APC} = \frac{\text{final consumption expenditure}}{\text{national disposable income}}$$

Source: Department of Statistics, National Income and Product, 1976; National Planning Agency, Economic and Social Survey, Jamaica, 1981.

Due to the high effective rate of tax the temptation for tax avoidance by legal means and evasion by illegal means is irresistible. It is notoriously difficult to obtain definitive estimates of the extent of tax evasion, but the evidence points to large scale tax evasion. It is noteworthy, for example, that the total number of employees reporting incomes of J$ 50,000 and above fell from 35 in 1975 to 14 in 1978, and was only 20 for the fiscal year ending in March 1980. The total number of taxpayers also fell from 138,056 in 1976 to 99,475 in 1979, a reduction of 28%. During the turbulent latter half of the 1970s in Jamaica, there were undoubtedly other contributing factors, but the evidence suggests that tax evasion is significant.

Widespread tax evasion, the increasing incidence of payment in kind, informal labour activity and unincorporated business activity are important factors in reducing the taxable base of the economy. Such widespread evasion increases the burden of those workers who are unable to avoid paying taxes and such workers are generally among the lowest paid. The reduction of the tax base also places a constraint upon the ability of the Government to increase revenue. It also limits the Government's ability to effect changes in economic activities through fiscal measures. These, of course, have clear implications on the Government's ability to increase expenditures without the budget deficit being significantly increased, as it has been in recent years. A tax policy which contributes to the erosion of its tax base thus gives rise to serious problems in the management of the economy and will undoubtedly contribute to the unnecessary growth in the national debt which itself raises additional difficulties.

REVISIONS

Any revision of the PAYE tax has to be made with the fact in mind that between fiscal years 1970/71 and 1982/83 total Government expenditure increased from J$ 260.5 million to J$ 2,771.4 million. The overall budget deficit was J$ 39.3 million in 1970/71, J$ 276.8 million in 1974/75 and J$ 864.9 million in 1982/83. There is no scope therefore for changes in major tax components, such as the PAYE tax, which will result in large net decreases in collections. At the same time, increased individual burdens will ensure that tax revenues increase very slowly. It is necessary, therefore, to increase PAYE revenues and to redistribute the burden simultaneously in order not to further stimulate evasion. Policies to redistribute the burden have to be implemented simultaneously with policies to increase the number of workers who pay PAYE for such a policy to be effective.

An appropriate PAYE tax structure does not so much require that the marginal rate of taxes be changed, but that the income levels on which they are levied be significantly increased. The current average rates are quite punitive.

Tax credits should be administered in real terms, as should the PAYE system as a whole. Increased revenues should be raised through deliberate policy and not through fiscal drag which hits the lowest paid the hardest.

It should be possible over time to put the PAYE on a better footing. In order to design an appropriate comprehensive tax policy covering direct and indirect taxes, it is necessary to have a good idea of the income distribution and expenditures. This information is usually obtained from a General Household Survey (GHS). The last GHS was carried out in Jamaica in 1972, so there is a clear need for more up-to-date information.

A BRIEF COMPARATIVE ANALYSIS

The introduction of PAYE in Jamaica in 1954 and Barbados in 1957 was, like many other Commonwealth countries, modelled on the United Kingdom's income allowance system. The administration of these systems, however, has developed quite differently.

Table 5 presents the marginal tax rates for Barbados, where the top marginal rate of 60% is not significantly different from the 57.5% of Jamaica. In Barbados the lowest rate starts at 10% and increases by 10 points until 60% is reached, whereas in Jamaica the base rate is 30%.

Neither Barbados nor Jamaica has a regularised inflation adjustment process in the administration of PAYE. The allowances are increased on an ad hoc basis.

Table 6 shows the allowances available in Barbados. In comparing Table 6 with Table 3 which shows the allowances for Jamaica, two things are noteworthy. The first is that there are many more allowance sources in Barbados. Secondly, the Barbadian allowances have been much better in maintaining their real value. Table 7 indicates that over the 1977-83 period, the retail price index

Table 5
Barbados PAYE tax rates, 1983*

Taxable income		*Tax rate*
(1) Up to B$ 5,000	@	10%
(2) Next B$ 5,000	@	20%
(3) Next B$ 5,000	@	30%
(4) Next B$ 5,000	@	40%
(5) Next B$ 10,000	@	50%
(6) The remainder	@	60%

* Prior to 1983, the top marginal rate was 70%, so that line (6) should have read "next B$ 10,000 @ 60%"; and a hypothetical line (7), "the remainder @ 70%".

Source: Department of Inland Revenue, Barbados.

Table 6
Barbados personal allowances 1983

Type of allowance	B$
Personal allowances	
Single	2,400
Married	4,500
Separated age over 65	4,000
Wife's earned income	5,000
[married person of age 65 or over whose spouse has no income]	
Children allowance	
under 12	400
12-16	500
over 16 edc. Barbados	600
edc. overseas	1,000
school fees (for children over age 11)	up to 350
Incapacitated dependent relatives	500
Housekeeper	500
Other dependent	500
Life insurance premium	up to 1,500
	up to 500 for each child
Medical [amt. in excess of B$ 20 up to a maximum]	single 150
	married 300
	each child 75
national insurance contributions	all of payments
Annual payments covenants	all of payments
Alimony or court order payments	all of payments
Provident or pension fund contribution	up to 1,500
Widows and children fund [for male Govt. employees only]	2% of salary
Gardener	up to 500
Deduction for residential property	
Interest on borrowed money	up to 6,000
Repair/improvements	up to 4% of improved value
Other prescribed improvements	full amt. on solar water heater installation
Savings with cooperative society	1,200
Repairs/improvements chattel house	up to 1,000
Subscriptions to	
trade unions	up to 240
statutory associations	up to 240
parliamentarians to a political party	up to 4,200
New shares in public company	up to 2,000
Rent paid for a dwelling house	up to 1,800

Source: Department of Inland Revenue, Barbados, April 1984.

of Barbados has doubled. Table 2 indicates that over roughly the same period consumer prices in Jamaica almost tripled, and we have shown above that the Jamaican tax credits have by and large remained constant over the period. Thus, even in the absence of inflation adjustments, the real value of Barbadian allowances would have fallen by less than those of Jamaica.

Table 7
Barbados retail price index 1977-83

Year	Index
March 1977	100.0
March 1978	112.3
March 1979	126.0
March 1980	150.4
March 1981	172.7
March 1982	187.6
March 1983	201.0

Source: Central Bank of Barbados, *Economic and Financial Statistics*, August 1983.

In Barbados, for example, the money value of the single person allowance in 1977 was B$ 1,200 and in 1983 it was B$ 2,400. The real value in 1983 of this allowance was virtually the same as in 1977. In the case of the married person allowance over 1977 and 1983, this has increased from B$ 2,000 to B$ 4,500 so that the real value in 1983 is greater than the 1977 value. In the case of Jamaica we have shown above that the 1983 real values are in almost all cases only 33% of the 1977 values. It is worth noting that personal allowances affect all PAYE taxpayers and are usually the single most important source of tax credits/allowances.

We may also note that the top marginal tax rate in Barbados is applicable on taxable incomes in excess of B$ 30,000 per annum – at the current exchange rate of B$ 2 to US$ 1 this is US$ 15,000 per annum. We reported earlier that the equivalent income for Jamaica is US$ 7,875 per annum.[8]

The evidence presented here is sparse but we may tentatively conclude that the Jamaican PAYE system is a more burdensome system than that of Barbados, and the Barbadian PAYE system appears to have been better administered over the 1970s period of inflation.

Barbados and Jamaica have enough in common to suggest that there is no intrinsic reason why the Jamaican PAYE must be characterised by substantial evasion and poverty-inducing features. The Jamaican PAYE system is sufficiently important to warrant serious consideration for reforms, but it is clear that such reforms cannot be conducted outside of the reform of the entire revenue structure.

In 1981/82 income taxes in Jamaica accounted for 42% of the total tax revenue, and PAYE accounted for about 60% of the latter. This means that PAYE accounted for 25.2% of the total tax revenue. It is an important contributor to Government revenue, but the very low exemption limits make the incidence of the PAYE regressive with its heavy burden on low incomes, and this gives rise to problems.

CONCLUSIONS

1. Whether the PAYE system is the Tax Credit System or the Income Allowance System makes no appreciable difference.

2. Inflation has eroded 66% of the real value of the tax credits between their introduction on 1 January 1977 and 1 December 1982. As such, the tax credits to encourage savings have lost much of their effect, and the real level of savings encouraged has also been eroded by two thirds.

3. The overall burden of income taxation under the PAYE tax is very high by past standards and internationally. Although the marginal rates are not uncommonly high, these rates are levied on relatively low incomes.

4. Fiscal drag has increasingly drawn low income earners into the tax net thus increasing poverty and hardship among low paid employees.

5. The overall PAYE structure encourages consumption although it sets out to encourage savings.

6. The high overall rate of taxation encourages tax evasion, especially in the absence of a well administered system. It also encourages a sub-optimal allocation of resources which will not maximise long-term growth potential.

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Albert-Hensel-Preis 1985

Zur Förderung des steuerrechtlichen Nachwuchses

Im Andenken an Albert Hensel (*1895, †1933), den bedeutenden Wegbereiter der modernen Steuerrechtswissenschaft und unter der Schirmherrschaft von Prof. Dr. Franz Klein, Präsident des Bundesfinanzhofs, schreiben die Herausgeber der Buchreihe „Steuerwissenschaft" einen Preis zur Förderung des steuerrechtlichen Nachwuchses aus.

Mit dem Albert-Hensel-Preis soll eine herausragende, bisher noch nicht veröffentlichte wissenschaftliche Forschungsarbeit eines jüngeren Verfassers ausgezeichnet werden, die sich mit dem Steuerrecht aus rechtswissenschaftlicher, betriebswirtschaftlicher oder finanzwissenschaftlicher Sicht befaßt (z.B. eine Dissertation oder Habilitation).

Die Auszeichnung umfaßt einen Geldpreis von DM 5.000,– verbunden mit dem Anspruch, die preisgekrönte Arbeit in der im Dr. Peter Deubner Verlag erscheinenden Buchreihe „Steuerwissenschaft" zu veröffentlichen.

Die Jury wird von dem Schirmherrn des Albert-Hensel-Preises, den Herausgebern und der wissenschaftlichen Gesamtredaktion der Buchreihe „Steuerwissenschaft" gebildet.

Bewerbungen und Vorschläge werden bis zum 31. Mai 1985 erbeten an die wissenschaftliche Gesamtredaktion der Buchreihe „Steuerwissenschaft", z.H. Herrn Prof. Dr. Heinz Mösbauer, Postfach 410268, 5000 Köln 41.

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