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(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.

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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".

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

Le Bureau public 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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S. Ambalavaner

With deep regret we announce that on 13 January 1985 Mr. Sivasubramaniam Ambalavaner, born on 24 October 1924, passed away. This is sad news for his numerous friends in all parts of the world.

Ambalam, as his friends called him, was a remarkable man. Based in Colombo, Sri Lanka, he travelled a great deal as a consequence of the many functions he held in international and regional legal organisations. His qualifications included that of Attorney at Law, Sri Lanka, Barrister-at-Law, United Kingdom, and Advocate, India. He was also, inter alia, chairman of the Sri Lanka National Council of the International Chamber of Commerce; vice-chairman of the Sri Lanka chapter of the Society for International Development; a governor of the Marga Institute (the Ceylon Institute for Development Studies); president of the Income Tax Payers Association, Sri Lanka; president of the Sri Lanka Environment Society; member of the Court of Arbitration of the International Chamber of Commerce and a technical advisor of ICC's Commission on Taxation.

Furthermore, he was chairman of the Sri Lanka branch of the International Fiscal Association, a member of the Advisory Council of the International Bureau of Fiscal Documentation and governor and chief executive of the Asian-Pacific Tax and Investment Research Centre, Singapore.

The positions he held included that of visiting lecturer in mathematics at the University of Ceylon, assistant assessor in the Department of Inland Revenue of Sri Lanka, and consultant to the U.N. Economic and Social Commission for Asia and the Pacific (ESCAP). He also was a discussion leader at the four ESCAP Seminars on Foreign Investment and Tax Administration in Manila (1974), Tokyo (1976), Sydney (1978) and Bangalore (1980).

Those who attended the 2nd Asia-Pacific Tax Conference held in Singapore hardly a month ago will not easily forget the brilliant lecture he delivered there.

It is no exaggeration to say that what Ambalam did not know about taxation in South-East Asia was not worth mentioning. He was a learned man in the true sense of this word. A practitioner of great repute, he was also an academic in his analysis of the principles of law. Those who had the privilege of hearing him speak, at conferences, seminars or workshops, were impressed by the simple manner in which he approached the most intricate problems. He was a born teacher who, during his brilliant lectures and comments as a panelist, never consulted notes or other papers.

Ambalam was a good friend. His hospitality was boundless and so was his respect for all who, in whatever function, worked with or for him. He had a delightful sense of humour which enabled him to approach human and professional problems with a nice feeling of proportion without, however, losing his sharp understanding of those problems and of people's reaction to them. He had also a deep love for his country and he was greatly disturbed and affected by what has been happening there over the last years. Only his good friends know how he was suffering from this and how it undermined his health.

The Bureau, the Centre in Singapore, the professional world in which he lived, and above all his friends owe him their gratitude for what he has given them.

J. van Hoorn Jr.

FEDERAL REPUBLIC OF GERMANY:

Taxation of Foreign Income – Principles and Practice *

By Klaus Vogel

Contents

Professor Dr. Klaus Vogel is Professor of Public Law (öffentliches Recht), in particular public economic law and tax law (öffentliches Wirtschafts- und Steuerrecht) at the University of Munich (Federal Republic of Germany). In this capacity he heads the research center for foreign and international finance and tax law at that university. Prof. Vogel is a member of the Permanent Scientific Committee of the International Fiscal Association (IFA) and Chairman of its Committee awarding the Mitchell B. Carroll prize. He is a member of the Board of Trustees of the German Branch of IFA and a member of the Scientific Advisory Board of the German Tax Law Association (Deutsche Steuerjuristische Gesellschaft). This paper is the English version of a talk given at the conference of the German Tax Law Association on 8-9 October 1984 in Heidelberg. See for a report on this conference, page 15 of this issue.

*"Practice," *says Kant, *"does not include every type of activity, but rather only that particular achievement of an end . . . that follows from adherence to certain generally posited principles."*[1] The introduction of the individual income tax, the value added tax, and, to some extent, the integration of the corporate income tax were examples of practice in this sense: each of these fundamental tax reforms was preceded by a thorough academic discussion that served as a preparation. If we ask ourselves whether the same can be said of our legislation regarding the taxation of foreign income and the agreements entered by the Federal Republic of Germany that relate thereto, the answer might be embarassing. "Adherence to certain generally posited principles" – would they satisfy such a rigorous definition of practice? Or do they not bear more resemblance to what Kant calls "fumbling with experiments and experiences"?[2]

In the first part of this presentation, I shall examine whether German rules regarding the taxation of foreign income are grounded in principles, and, if so, which ones. In the second part, I would like to suggest principles which should guide a reasonably just system of foreign income taxation.

I. THE TAXATION OF FOREIGN INCOME UNDER CURRENT GERMAN LAW

1. The principle of worldwide income and the principle of territoriality

At first glance, it seems as if we would not need to search very far for the underlying principle. The principle with respect to which the taxation of foreign income is determined according to German law – this much we all have learned – is that of the taxation of domestic taxpayers with respect to their worldwide income (also referred to as the "Universality Principle" or the "Totality Principle"), whereas non-residents are taxed only with respect to domestic-source income. This, indeed, is the statutory rule. Upon closer examination, however, it becomes apparent that our taxation of worldwide income is, in part, limited, and, in part, and this to a considerable degree, non-existent.

It is no longer possible to discuss taxation of foreign-source income without considering at the very outset that German national income tax and corporate tax law is limited and affected by numerous double taxation agreements concluded by the Federal Republic of Germany. Such agreements exist with all important and many less important trading partners of the Federal Republic.[3] They apply in the same manner as does domestic law;[4] only national law and treaty law taken together constitute the authoritative international tax law of the Federal Republic of Germany – here: the law of the taxation of foreign-source income.[5] Even if no statistics exist, we are justified in presuming that the vast majority of our international tax cases today are determined not only through application of domestic law, but rather by its application in conjunction with the terms of a double tax treaty.

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* The original German version of this conference, held 8 October 1984 at Heidelberg, will be published in: *Grundfragen des Internationalen Steuerrechts,* Verlag Dr. Otto Schmidt KG, Köln (1985).

[1] Kant, Über den Gemeinspruch: Das mag in der Theorie richtig sein, taugt aber nicht für die Praxis (Concerning the common saying: "That may be correct in theory; however, it does not apply in practice") *Berlinische Monatsschrift* 201, 202 (September 1973), here according to: 6. *Werke* 125, Weischedel (Editor).

[2] *Id.* at 203 and 128.

[3] Overview according to the situation on 1 January 1984, *Bundessteuerblatt* I, 3 (1984).

[4] K. Vogel, *Doppelbesteuerungsabkommen, Kommentar,* Introduction, paragraph 21 *et seq.* (1983) (hereinafter cited as "DBA").

[5] Bühler, *Prinzipien des Internationalen Steuerrechts,* 1 (1964). *See also Völkerrecht und Landesrecht im internationalen Steuerrecht,* 19 *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht* 668 (1958); *Steuerrecht, Internationales,* in 10 Handwörterbuch der Sozialwissenschaften p. 149.

When we take into account this working relationship of domestic law and treaty law it is no longer possible to maintain that the principle of worldwide taxation takes precedence. At a Munich symposium last year, Thomas Menck correctly noted that, according to our treaties (and their application is the usual case) the territoriality or source principle – that is, taxation of domestic-source income only, even with regard to resident taxpayers – constitutes a "fundamental element of our . . . tax system", too.[6] German tax treaties usually exempt business income from a permanent establishment abroad,[7] income from independent services attributable to a fixed place of business abroad,[8] income from employment abroad,[9] income from real property situated abroad,[10] as well as earnings from affiliates,[11,12] to name only the most important groups. Even where treaty rules allocate taxation of residents to the Federal Republic as the country of residence, as in the cases of business profits that are not attributable to a permanent establishment,[13] profits from air or sea shipping,[14] short-term activity abroad,[15] compensations and pensions from public service[16] and so forth, this is not a confirmation of the worldwide income principle; rather the source in such cases is viewed as being situated in the state of residence. The principle of worldwide taxation according to German tax treaties only applies in the case of dividends from portfolio investments, interest and royalties, with a limited tax in the source country that is generally credited in the country of residence.[17] With respect to developing countries, even these types of income are often completely or partially exempt: the technical vehicle here is the credit of fictional taxes through a so-called "tax sparing credit" or "matching credit".[18] Further, worldwide income taxation continues to apply where newer treaties prescribe a credit rather than an exemption in exceptional cases, as, for example, for income from real property according to some treaties,[19] or, more frequently, for profits from inactive permanent establishments.[20]

The exemption of foreign income in such cases serves not only to achieve the avoidance of double taxation. This question has been discussed within the context of the General Agreement on Tariffs and Trade (GATT) where the United States maintained that, because a credit suffices to avoid double taxation, an exemption constitutes a GATT proscribed export subsidy.[21] This is not justified; the exemption implies more than a double taxation relief. Certainly: in granting an exemption, the treaty does not allocate, as is sometimes said, "the right to tax," because the right of a country to tax is a part of its sovereignty, and treaties can only bind countries, they do not transfer sovereignty. Through the exemption, however, the country of residence acknowledges the primary jurisdiction of the country of source to determine the tax burden of income generated within its territorial boundaries, and it acknowledges the right of the taxpayer to be treated for tax purposes similarly to those who have generated income under the same basic conditions: that is to say, the same conditions as in the country of source. In addition to supporting source-country taxation in this way, the "dividends received deduction" serves to eliminate or at least reduce the double burden resulting under the classic corporate income tax law;[22] as a result only a reduced amount of tax in the source country is left[23] that is not credited in the Federal Republic. This amount can be understood as a remaining taxation taking account of the indirect costs of a participation[24], costs which the taxpayer is not obliged to charge off against his dividends, neither under treaty nor under domestic law (comparable to the "quote-part de frais et charges" under French and Belgian law).[25]

In view of this choice in favor of the exemption as the fundamental concept of our treaty policy, the question quite naturally arises why the principle of worldwide taxation continues to apply under our law: first, to those types of income for which a credit is provided, primarily dividends from portfolio investment, interest and royalties; and, second, to income from countries with respect to which no double taxation agreement exists. That it may be convenient to retain a pawn in order to obtain concessions in treaty negotiations is of little comfort to the taxpayer who is forced to play this role of the pawn (if not that of the hostage). Other countries allow unilateral exemptions to a much larger extent: Switzerland exempts income from permanent

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[6] Menck, Welteinkommen und Territorialität der Besteuerung nach deutschem Recht und in deutscher Sicht, in: *Steuern auf ausländische Einkünfte*, Engelschalk/Flick u.a. (7 Münchener Schriften zum Internationalen Steuerrecht) 28 (1984).

[7] Cf. Art. 7 OECD Model Treaty (hereinafter cited as "MT").

[8] Cf. Art. 14 MT.

[9] Cf. Art. 15, (1) MT.

[10] Cf. Art. 6 MT.

[11] However, the amount of the exemption is determined in another manner. Regarding the various types of exemptions, *see* (Reichsfinanzhof) *Reichssteuerblatt* 1938, p. 67, Bundesfinanzhof *Bundessteuerblatt* 1967 III, p. 92, 94, 1971 II, p. 694, 696, 1973 II, p. 508, 509.

[12] Overview in K. Vogel, *DBA*, Art. 23 (23) *et seq.*

[13] Art. 7, MT.

[14] Art. 8, MT.

[15] Art. 15 (2) MT.

[16] Art. 18, 19, MT.

[17] Cf. Art. 10, Para. 2, 23 A Para. 2, 23 B MT. Approximately half of the German treaties contain similar rules for royalties. See K. Vogel, *DBA*, Art. 12, Para. 21.

[18] K. Vogel, *DBA*, Art. 23, Para. 117 *et seq.*

[19] DBA Ivory Coast, Art. 23 (1); Finland, Art. 23 (5); Korea, Art. 24 (1); Spain, Art. 23 (1); Tunisia, Art. 23 (1). Furthermore, the treaties with Argentina, Brasil, and Switzerland prescribe a credit.

[20] *See* The overview from K. Vogel, *DBA*, Art. 23 (39) and 84 *et seq.*

[21] To ameliorate criticism that the American DISC legislation violates GATT, the United States claimed that exemption of certain foreign income as granted by France, Belgium and the Netherlands to their residents also was contrary to GATT. A panel appointed by the GATT council in 1973 determined that the claims were valid (Reports from 2 November 1976, GATT document L/4423, 4424, 4425. *See* Intertax 1977, p. 68 *et seq.*, 103 *et seq.* 111 *et seq.*). The council, however, did not follow the panel's decision, it held on 8 December 1981 that no obligation to tax foreign economic transactions results from the treaty. *See* Harwood, The GATT/DISC Dispute, 25 *Taxes International* 3 (1981).

[22] MT, Commentary Art. 23, No. 49; K. Vogel, DBA, Art. 23 Para. 95.

[23] Art. 10, (2(a)) MT.

[24] According to Art. 10 MT and the principles developed in application of § 9 Körperschaftsteuergesetz (prior to 1977).

[25] *See* K. Vogel, Steuerliche Behinderungen des internationalen Kapitalflusses zwischen einer Muttergesellschaft und ihrer Tochtergesellschaft, CDFI LXIXa, 15 *et seq.* (25). *See also l.c.*. Delwaide, *National Report*, 225, and the Feydeau, *National Report*, 339.

establishments and real property located abroad,[26] the Netherlands exempts foreign source income generally if the income is taxed in the source country,[27] Australia does the same.[28] It is not known that these countries are in a worse position with respect to entering treaties than we are. Retaliatory provisions may help with respect to countries that are especially obstinate in their efforts to obtain their particular wishes regarding taxation.[29] German law, moreover, also provides a unilateral exemption in one instance: for dividends received from subsidiary companies located in developing countries under § 26 (3) KStG pursuant to application of the fictive credit. Apart from this, the "pawn theory" does not account for the fact that dividends from portfolio investments, interest and royalties are not exempt under treaty law.

I do not want to allow one other important limitation on the worldwide income principle to go unmentioned: it results from the recognition of foreign juridical persons as independent taxable entities. Authors on public finance correctly maintain[30] that it is possible, at least, to include the profits of the taxpayer from participation in foreign legal entities in calculating his worldwide income. Recognition of the legal entity as a taxable entity itself prevents this result. I must confess: I had difficulties at first seeing an independent limitation of the concept of worldwide income taxation in these provisions. As lawyers, we generally view recognition of the legal entity as the norm and nonrecognition as the exception. However, others, particularly Anglo-Saxon authors, see this the other way around: they consider the recognition of the legal entity as the allowance of a tax "deferral", that is, they consider immediate taxation of profits at the shareholder level to be preferable.[31] Of course, this would require proof; the term "deferral" presupposes it, and, therefore, I think it would be more correct not to use the word. One must admit, however, that the view of the public finance authors is equally valid, and that it is as justifiable as ours. Consequently, the recognition of the juridical personality as the taxable entity does in fact lead to a – not unimportant – limitation to the concept of worldwide income taxation.

To summarize, our current law has not decided clearly for either the principle of worldwide income taxation or for the territoriality principle. Worldwide income taxation is the statutory rule (§§ 1, 2 EStG; § 1 KStG); in practice, however, the territoriality principle predominates. Our law remains suspended between both.

2. Taxation of base companies

Indecision regarding the principle of taxation of foreign income – or its non-taxation – generates uncertainty not only where application of the law is concerned , but also at the perimeter where legal policy assessments of factual situations are made, in legislation. This is demonstrated clearly by the German *Aussensteuergesetz* ("Foreign Tax Law" hereinafter referred to as the "AStG").

"Germany admired the section 482 regulations enough to copy them," says an American author.[32] Certainly, the adoption of established legal rules from other countries is not objectionable: Europe has adopted various civil rights, the concept of constitutional democracy and judicial review of the constitutionality of laws from the United States – institutions that we would not like to do without. Whoever wanted to imitate the American foreign tax legislation from the early 1960s, the so-called Kennedy tax reform, however, should have considered two details: First, the United States did not initiate its concerted effort to limit the accumulation of profits outside its borders and to tax the profits of foreign base companies until after the balance of trade in the United States became severely and consistently negative toward the end of the 1950s.[33] Second, in contrast to German practice, the international tax law of the United States has applied the principle of worldwide income taxation consistently. Rather than granting exemptions under its double taxation agreements, the United States allows only a credit;[34] the United States Senate decidedly refused to allow the tax sparing credit, even for developing countries. Given such principles, non-taxation under certain circumstances appeared objectionable in cases in which it would not be objectionable under German law.[35] Rather than taking these differences into consideration, we uncritically adopted the American view.

Application of the rules of tax avoidance provided only an insufficient solution of the base company problem. This also was a result of the indecisiveness in our tax law in choosing between two opposed principles. According to the case law of the Federal Fiscal Court, § 6 *Steueranpassungsgesetz* (Tax Accommodation Law) and the current § 42 *Abgabenordnung* (Law on Tax Administrative Procedure) (AO) should prohibit tax results that are "disallowed by reasonable interpretation of the law that takes into account the purpose and goal

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[26] Exemption with progression: *see* Höhn/David, *Doppelbesteuerungsrecht,* 82 (1973); Ryser, *Introduction au Droit Fiscal International de la Suisse,* 35 (1980); Constantin, Unilaterale Massnahmen zur Vermeidung der Doppelbesteuerung, *National Report,* CDFI LXVIb, 449.

[27] Strik, Tax Avoidance in International Transactions, *Netherlands Reports to the Eleventh Congress of Comparative Law,* 383 (1982); Overbosch, *National Report,* CDFI LXVIb, 383, 390.

[28] Mayes/Rollo, *National Report,* CDFI LXVIb, 191, 192.

[29] As in § 12 para. 3 Vermögensteuergesetz; the content of the provision, as well as its application (or nonapplication) by the Fiscal Administration, is problematic. *See* Mössner, Steuerfreiheit bei Auslandsvermögen nach § 12 Abs. 3 VStG, *Internationale Wirtschaftsbriefe* 17 (10/1/1983) (3 Dtschld. Gr. 8 p. 155). Regarding retaliatory provisions, *see* Blumenstein, Zur Frage der Steuerretorsion, 4 *Vierteljahresschrift für Schweizerisches Abgabenrecht* 97 (123).

[30] *See* Gandenberger, Kapitalexportneutralität versus Kapitalimportneutralität, 9 *Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz, Aufsätze zur Wirtschaftspolitik,* 25.

[31] Surrey/McDaniel/Pechmann, *Federal Tax Reform for 1976,* 76 (1976). Regarding this book and the numerous legislative attempts in the USA "to eliminate deferral", that is: to tax the parent corporation on profits earned by its subsidiaries, *see* Kingson, The Coherence of International Taxation, 81 *Col. Law Review* 1151 (1981).

[32] Kingson, The Coherence of International Taxation, 81 *Col. Law Review* 1151, 1163 (1981).

[33] *Id.,* 1175.

[34] Originally, the treaties merely provided that domestic provisions of the IRC applied over the foreign tax credit. The gradual transformation to an independent treaty foreign tax credit is discussed in Gann, The Concept of an Independent Treaty Foreign Tax Credit, 38 *Tax Law Rev.* 1 (1982).

[35] This is apparent through the GATT disagreement. *See* note 21 supra.

of the legal system."[36] § 42 shall, according to Klaus Tipke, "supply recognition for the underlying purpose of the law that is not encompassed in the statutory language."[37] According to Paul Kirchhof, § 42 demands "a conceptual evolution of the ratio of the law (ein Weiterdenken des Gesetzesgedankens) . . . independent of the actual text."[38] If a law, however, juxtaposes two undifferentiated "ratios of the law," their "conceptual evolution" is not possible, and a tax avoidance then cannot be established. In other words, if the German treaties exempt particular types of foreign income; if the German domestic law acknowledges the effect of recognition of the legal entity for tax purposes; then the utilization of these possibilities cannot be improper. This conclusion is reaffirmed by the case law of the Federal Fiscal Court, which has held that revision by application of § 42 AO is possible only in borderline cases.[39].

The development through the tax haven report[40] and the tax haven decree[41] is well known. In 1972 the demand for tax reform led to the somewhat rash promulgation of the Foreign Tax Law (AStG).[42] This law did not attempt to modify and apply rules adopted from German law, such as those applying to the allocation of profits, or the rules on disguised distributions of profits and disguised contributions to capital.[43] Rather, it slapped new legal principles adopted from the United States on top of traditional German principles, like a tin roof on a Tudor house, without regulating the relationship of the two to each other.[44] Thus, it did not eliminate the fundamental indecisiveness inherent in German international tax law: the AStG itself perpetuates this indecisiveness. Here, I only develop this point by reference to the problem of taxation of base companies, and then only in abbreviated form.

According to my interpretation, §§ 7 et seq. AStG should be understood as providing reserve criteria to the normal requirements of an income tax obligation under § 2(1) *Einkommensteuergesetz* (Individual Income Tax Law) (EStG); they are comparable to the reserve criteria through which particular opportunities of avoiding the real property transfer tax or the capital transfer tax are made subject to taxation under § 1 No. 2 et seq. *Grunderwerbsteuergesetz* (Real Property Transfer Tax Law) or § 2 No. 2 *Kapitalverkehrsteuergesetz* (Capital Transfer Tax Law).[45] An outline of § 2 (1a) EStG, through which the additional taxation would be systematically inserted into the EStG, is attached as Annex 1.

Whether this kind of taxation is justified, and why, is, however, not established simply by integrating it within the system of the EStG. The AStG remains undecided regarding this issue, too. The term "Zugriffsbesteuerung"[46] as it is used by some German authors seems to suggest that we should not bother seeking a justification: the State takes because the State can take. Such thinking would be unacceptable for a state governed by law, and, therefore, I think the expression, too, cannot be accepted. The addition of base company income to that of a parent company can only be justified if and because the income of the base company can be understood to indicate ability of the parent company to pay.[47] But how, in turn, are we entitled to make such an assumption? Is the domestic person made responsible for the accomplishments of the foreign corporation? Is its income attributed to him as his personal income? Or does the law see in the – not yet realized – possibility of obtaining the anticipated income of the base company through a distribution a capacity (ability to pay) of the shareholder himself, in the light of which this anticipated income is taxable to him as if the income already had been distributed? It is to Franz Wassermeyer's great merit to have raised this question.[48] In my opinion, however, he assesses the statutory language of § 7 too highly; § 951 of the United States IRC proves that the tax allocation criteria can be rewritten without essential change in a manner that would not allow Wassermeyer's conclusion.[49] So, it appears to me that the allocation of the additional taxation can be justified only in view of the possibility of distribution of profits by the base company. The concept of capacity to pay and the fiction of a distribution are not contradictory con-

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36. BFH BStBl. 1958 III p. 97 (99), 1964 III p. 667 (669), 1965 III p. 697, 1966 III p. 148 (150), 1970 II p. 675, 1971 II p. 721 (722), 1972 II p. 322 (324), 1974 II p. 521.

37. Tipke/Kruse, *Abgabenordnung, Finanzgerichtsordnung* (11th ed. 1983) (looseleaf edition) § 42 Tz. 6.

38. Kirchhof, Steuerumgehung und Auslegungsmethoden, *Steuer und Wirtschaft* 173, 174 (1983).

39. Bundesfinanzhof *Bundessteuerblatt* 1970 II, 554, 1975 II, 553 (555), 1977 II, 265 (266), 1981 II, 339, 1982 II, 150, *Höchstrichterliche Finanzrechtsprechung* 1984, 261.

40. Bericht der Bundesregierung an den Deutschen Bundestag über Wettbewerbsverfälschungen, die sich aus Sitzverlagerungen in das Ausland und aus dem zwischenstaatlichen Steuergefälle ergeben, *Bundestagsdrucksache* IV/2412. (Federal Government Report to the Federal Parliament regarding distortion of competition resulting from emigration of companies and differences between various national tax systems).

41. Erlass (koord.) betr. Verlagerung von Einkünften und Vermögen in sogenannte Steueroasenländer, *Bundessteuerblatt* 1965 II, 74. (Decree regarding accumulation of income and wealth in so-called tax haven countries).

42. *See:* Ritter, Zur Frage der Bewährung des Aussensteuergesetzes aus der Sicht der betroffenen Wirtschaft, *Steueroasen und Aussensteuergesetze*, Vogel/Ellis u.a. (3, Münchener Schriften zum Internationalen Steuerrecht), 75 (1981); Koch, Zur Frage der Bewährung des Aussensteuergesetzes aus der Sicht der Verwaltung, *Id.*, 83; Wassermeyer, Erfahrungen mit dem Aussensteuergesetz von 1972, *Staatsfinanzierung im Wandel, Verhdlg. auf der Jahrestag. des Vereins für Sozialpolitik 1982*, 573 (1983); and Elf Jahre Aussensteuergesetz, *Recht der Internationalen Wirtschaft*, 461 (1984).

43. *See* K. Vogel, Bemerkungen zur Gewinnverwirklichung und Gewinnberichtigung im deutschen Aussensteuerrecht, *Steuer und Wirtschaft*, 193, 200 (1974).

44. Woerner, Verdeckte Gewinnausschüttungen, verdeckte Einlagen und § 1 des Aussensteuergesetzes, *Betriebs-Berater*, 845 (1983).

45. *See* Hensel, *Steuerrecht*, 95 (3d Ed. 1933) regarding "Ersatztatbestände" (reserve criteria).

46. A legal term is not involved here, rather a use of language in the literature.

47. Menck in: Blümich/Falk, *Einkommensteuergesetz*, (11th Ed. 1976) (looseleaf service), Vorb. §§ 7 – 14 AStG (28).

48. Wassermeyer in: Flick/Wassermeyer/Becker, *Kommentar zum Aussensteuerrecht*, 4th Ed. 1983) (looseleaf service), § 7 Anm. 7b, 7e; *id.*, Die Vereinbarkeit der Hinzurechnungsbesteuerung nach dem Aussensteuergesetz mit dem Grundgesetz und den Vorschriften der Doppelbesteuerungsabkommen, 2 *Festschrift Flume*, (Köln 1978), 323; *id.*, Die Hinzurechnungsbesteuerung als Qualifikationsproblem des nationalen und des internationalen Steuerrechts, *Recht der Internationalen Wirtschaft*, 352 (1983).

49. "If a foreign corporation is a controlled foreign corporation . . . every person who is a United States shareholder . . . include in his gross income . . . (A) . . . (i) . . . his pro rata share . . . of the corporation's subpart F income . . ." (etc.).

cepts;[50] they complete each other. Even the legal consequences resulting from the application of the AStG correspond to those of a presumed distribution. That is important especially for the application of double taxation agreements.[51]

Most importantly, the AStG fails to make a fundamental decision regarding which types of a subsidiary company's income are to be considered "prejudicial" and, therefore, to be included into the parent company's taxation. American law in this area is founded in relatively clear and administrable principles. Owning a majority capital interest is differentiated from owning a voting majority of stock. More than 50% stock ownership in a foreign corporation in the hands of a small circle of domestic persons qualifies the corporation as a Foreign Personal Holding Company and leads to the attribution to the shareholders of the income that was produced through the investment of capital, that is "passive" income.[52] The controlling thought here is that the shareholders could have produced such income domestically. More than 50% voting interest in the hands of domestic persons qualifies the corporation as a Controlled Foreign Corporation; in addition to passive income, certain other types of income of the corporation are allocated to the shareholders here, if the income is produced under circumstances that make possible a manipulation of corporate profits.[53] In contrast the AStG lumps together the cases of ownership of a majority of capital and of a voting majority, as well as passive income and income that may be subject to manipulation. If one endeavors to extrapolate from § 8 AStG those types of income that are "prejudicial", one still can recognize the bifurcation taken from the American law; I refer to Annex 2. However, because the AStG does not relate the reason for reallocation to its full extent, it seizes upon the opportunity to infer the reallocation of certain types of income – their "harmfulness" – from an underlying ratio, whatever it is.[54] The scope of these types of income, as listed in § 8, is, therefore, arbitrary, to a great extent unintelligible and, in detail, bizzare.[55] The indecisiveness regarding which types of income are to be taxed is continued here. If, however, the rationale of the law is not precise, its interpretation can only be arbitrary.

How little even German taxation authorities have been able to grasp the entire system of their AStG is demonstrated by their attempt to attribute items of income under § 7 (4) AStG that would not be attributable pursuant to § 7 (1). If this interpretation were correct, an attribution would be possible even in the case of persons who neither directly nor indirectly owned interests in the foreign corporation and, therefore, never would be able to enjoy a distribution: for example, in the case of a guardian who, in the course of the representation of his ward, is empowered to direct the custodian of an interest in a corporation. The Federal Fiscal Court correctly overruled this interpretation;[56] however, now it is intended to be carried out through a legislative change.[57]

3. Briefly concerning losses

A few comments regarding the treatment of foreign losses: here we can discern in current German income tax law not less than four different types of treatment, assuming correctness of the case law and the administrative interpretation, as well as the constitutionality of § 2a EStG;[58]

- Total deduction of the loss against domestic income with a carryback and a carryforward. This is the case where no treaty exists, or an existing treaty applies the credit method, and the types of income involved do not fall under § 2a EStG.
- Deduction with carryback and carryforward, but with subsequent recapture upon realization of foreign profits. This is possible upon election in the cases of § 2 *Auslandsinvestitionsgesetz* (Foreign Investment Law).
- Consideration of losses within the progressive tax structure. This possibility exists where the treaty provides for an exemption for types of income that do not fall under § 2a. The rule is peculiar in that it causes losses that are so small in relation to the positive items of income to have little effect; however, losses that outweigh the positive items of income eliminate the tax liability, in which case a remaining income is subject to an especially high rate of progressivity.[59]
- Finally, foreign losses are not deductible in cases falling under § 2a.

No one would maintain that this quadruple rule is especially convincing. In addition, § 2a EStG creates possibilities for politically undesirable tax planning.[60] It has not yet been established that § 8 (2) Körperschaftsteuergesetz (Corporate Tax Law) is not applicable. The "umgekehrte isolierende Betrachtungsweise" (the reversed isolated method of construction)[61] is a slogan with suggestive strength; however, it is no substitute for

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[50] So, possibly, Menck, note 47 *supra.*

[51] K. Vogel, DBA, Art. 10, Para. 192.

[52] IRC § 954 (a) and (c); IRC § 553.

[53] Foreign base company sales income (IRC § 954 (d)), foreign base company services income (IRC § 954 (e)) and income derived from the insurance of United States risk (IRC § 953).

[54] § 7 (2) AStG.

[55] Flick/Wassermeyer in Flick/Wassermeyer/Becker note 48 *supra,* § 8 Anm. 3, 6a and more often Wassermeyer, "Elf Jahre", note 42 *supra,* p. 465. Regarding specific questions under § 8 in the same vein, *see:* Flick, Schädliche Mitwirkungstatbestände im Aussensteuerrecht, *Finanzrundschau* 6 (1976); Hollatz/Moebus, Steuerliche Beurteilung von Finanzierungsgeschäften im Ausland, *Der Betrieb* 605 (1978); Merkert, Die aussensteuerliche Mitwirkung bei Handels- und Dienstleistungsgesellschaften, *Der Betrieb* 1861 (975); Telkamp, Der Aussensteuergesetz-Entwurf, *Steuer und Wirtschaft* 97, 110 (1972).

[56] Judgment from 26 October 1983 *Bundessteuerblatt* 1984 II, 258.

[57] Entwurf eines Steuerbereinigungsgesetzes 1985, Bundestagsdrucksache 10/1636, Art. 7 No. 1.

[58] Manke has made noteworthy comments regarding § 2 a. *See* Manke, Angeklagt: § 2 a EStG, Plädoyer für und an den Gesetzgeber, *Deutsche Steuerzeitung, Ausgabe A* 235 (1984).

[59] K. Vogel, DBA, Art. 23, Para. 205.

[60] K. Vogel, Verbot des Verlustausgleichs für bestimmte ausländische Verluste, Der neue § 2 a des Einkommensteuergesetzes, *Der Betriebsberater* 180, 183 (1983).

[61] Bopp in: Hermann/Heuer/Raupach, *Einkommen- und Körperschaftsteuergesetz mit Nebengesetzen,* (19th Ed. 1982) (looseleaf service), § 2 a No. 32; Heinicke, in: Schmidt, *Einkommensteuergesetz,* (3d Ed. 1984) regarding § 2 a Note 4 a.

proof.[62] Consequently the indecisiveness of our foreign tax law, the state of suspension between the principle of worldwide income taxation and the territoriality principle, is confirmed once again through the provisions of the Foreign Tax Act and through the rules for the treatment of losses.

II. THE TAXATION OF FOREIGN INCOME ACCORDING TO PRINCIPLES OF INTERNATIONAL JUSTICE

1. View of experts

Given the previous discussion, I do not think I need to prove that there are reasons to look for principles upon which a just form of taxation of foreign income could be based. This question has rarely been raised.

The taxation of worldwide income can be traced back to Adolph Wagner, to whom still other basic principles of current German income tax law also can be traced.[63] For Wagner, worldwide income taxation follows from the postulate that taxes should be general in order to cover all types of income in the same manner.[64] Wagner did not consider it to be significant that double taxation would result from this. He did not view foreign investment as especially desirable; avoidance of double taxation was not a question of justice for him, but rather one of expedience.[65] Wagner's view follows the tendency to national egotism that was coming into fashion during his time. The economic self interest of the State was deemed to be most secure through self sufficiency.[66]

In contrast, an article, "Zur Frage der Steuerpflicht" (Regarding Tax Liability),[67] written in 1892 by Georg v. Schanz, the author of the "Reinvermögenszugangstheorie" (the net wealth accretion theory, developed in the United States by Robert M. Haig and Henry L. Simons) had little impact. Schanz wanted to allocate taxation between countries of source and countries of residence, allocating the larger portion, three fourths, to the country of source, and one fourth to the country of residence.[68] All that remains from his deliberations is the expression "Wirtschaftszugehörigkeit" ("economic allegiance");[69] it is common even today, but only as a blanket term that everyone uses as he chooses. The experts appointed by the League of Nations in 1923[70] spoke of "economic allegiance"; against v. Schanz, however, and with a very problematic reasoning,[71] neither technically convincing nor politically acceptable, they concluded from the concept that the country of residence alone should be justified in taxing income.[72] Herbert Dorn changed the term to "staatswirtschaftliche Zugehörigkeit" ("state economic allegiance") which introduced the pragmatic aspects of enhanced ability to determine, control and enforce taxation as considerations justifying taxation in addition to the aspect of economic connection.[73] Concerning the expanded discussion that followed, it may suffice to refer to Armin Spitaler and Ottmar Bühler.[74]

Legal experts and practitioners in Latin America have argued for decades for limiting taxation to domestic income alone.[75] In Europe, during the Age of Enlightenment, the territoriality principle was understood as the self-evident limitation of national legislation.[76] Even more recently, a decision of the House of Lords treats it as a subsidiary legal principle that is to apply if the legislator provides no express rule.[77] In Latin America, the territoriality principle was initially grounded in international law.[78] Today, this is no longer maintained. It is evident, moreover, that territoriality does not provide an unequivocal solution for each detailed question, but rather is susceptible to various interpretations: in the British remittance basis taxation of non-domiciled residents only,[79] in the French reliance on a "cycle complet d'opération",[80] in a South African interpretation that defines source so broadly that it practically subsumes worldwide income.[81] Even in Latin America, as a symposium with tax experts from Latin America in Munich last year showed, despite fundamental agreement in theory, the principle is applied differently by the States in answering questions of detail.[82] Nevertheless, this corresponds to the essence of a principle: principles do not provide universal solutions, but rather general rules that must be made concrete through legislation, as can

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62. *See* K. Vogel, Die 'umgekehrte isolierende Betrachtungsweise'. Über die Suggestivkraft einer Wortschöpfung. *Der Bundesfinanzhof und seine Rechtsprechung, Festschrift für v. Wallis* (1985).

63. Concerning Adolph Wagner, *see* Birk, *Das Leistungsfähigkeitsprinzip als Maßstab der Steuernormen,* 26 (1983).

64. Wagner, *Finanzwissenschaft, Zweiter Teil: Gebühren und allgemeine Steuerlehre,* 296 (1880). Regarding the development of this thought from the "Sacrifice Theory", *see* Vogel, Wie geht es weiter? Die Zukunft des Oasenproblems, in: *Steueroasen und Aussensteuergesetze,* footnote 42 *supra* at 128.

65. Id., 311.

66. *See* K. Vogel, Die Verfassungsentscheidung des Grundgesetzes für eine internationale Zusammenarbeit, 292/293 *Recht und Staat* (1964) 10, 15.

67. 9 *Finanz-Archiv* 365 (1892).

68. *Id.*, 375.

69. *Id.*, 372.

70. League of Nations, Economic and Financial Commission, Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, Geneva, 5 April 1923.

71. *See* Dorn, Das Recht der internationalen Doppelbesteuerung, *Vierteljahresschrift für Steuer- und Finanzrecht,* 189, 210 (1927); v. Schanz, Die Doppelbesteuerung und der Völkerbund, 40 *Finanz-Archiv* 353 (1923).

72. *See* League of Nations, note 70 *supra* at 45.

73. *See* Dorn, note 71 *supra* at 212.

74. Spitaler, *Doppelbesteuerungsproblem bei den direkten Steuern,* 219, 256, 328 (1936) (unchanged 2d Ed. 1967); Bühler, *Prinzipien des Internationalen Steuerrechts,* 130 and 161 (1964).

75. For an overview of the discussion in German, *see* Valdes Costa, Entwicklung und theoretische Fundierung des Territorialitätsprinzips in Lateinamerika, in: Besteuerung ausländischer Einkünfte, note 6, *supra* at 43.

76. K. Vogel, *Der räumliche Anwendungsbereich der Verwaltungsrechtsnorm,* 81 and 89 (1966).

77. Clark (Inspector of Taxes) v. Oceanic Contractors, Inc., *Simon's Tax Cases* 35 (1983).

78. *See also* Palamarchuk, Plurimposición Internacional, revista de la Facultad de Derecho y Ciencias Sociales (Montevideo) 10, 949 (1959).

79. A dissertation on this subject by S. Kern will appear in the near future (University of Mainz).

80. Tixier/Gest/Kerogues, *Droit fiscal international,* 62 (2d Ed. 1979); *See also* Lefebvre/Pöllath/Rädler, *Steuern in Frankreich,* 11 (1976); Norr/Kerlan, *Taxation in France (World Tax Series),* 270 (1966).

81. Silke, *South African Income Tax,* 120 (5th Ed. 1967).

82. Gnazzo, Der Einfluss des Territorialitätsprinzips auf das Einkommensteuerrecht der lateinamerikanischen Staaten, in: *Besteuerung ausländischer Einkünfte,* note 6 *supra,* at 57; Engelschalk, Was bedeutet Territorialität im konkreten Fall? Ergebnisse einer Fragebogenaktion, *op. cit.* at 74.

be noted especially from the numerous and different concrete rules that have been derived from the ability to pay principle.[83]

In Latin America, to support taxation according to the territoriality principle authors rely more and more on arguments of development policy.[84] It would be incorrect, however, to simplify this by saying that the territoriality principle is a maxim followed by developing countries, the worldwide income taxation by industrial countries. A discussion of the subject under the auspices of the International Academy of Comparative Law in Caracas in 1982 demonstrated clearly that:[85] on the one hand, less developed countries in Southern Europe, Southeast Asia, as well as all the countries of the COMECON adhere to the worldwide income principle; on the other hand, France, which is still the fourth largest exporting country in the world, applies the territoriality principle to corporate income, and in the Netherlands, Switzerland and Australia, foreign income, as previously mentioned, is exempted from taxation to a considerable extent.[86] In Germany, Hans Flick, who emphasized this again last year, Klaus Tipke, Arno Schulze-Brachmann, Horst-Walter Endriss – and if I may mention my own publication – have all argued for taxation according to the territoriality principle (Flick for a "modified" territoriality principle).[87] In Great Britain in 1955, a Royal Commission spoke for the priority of taxation in the source country.[88] On the international level, J. van Hoorn Jr. has argued to limit taxation in the country of residence to those types of income that are transferred out of the source country and into the country of residence.[89] The International Chamber of Commerce, which had been one of the primary advocates of taxation of worldwide income during the twenties,[90] adopted a resolution in 1955 granting the country of source "the sole right" to taxation and has repeatedly adhered to this resolution in subsequent years.[91] And, finally, the International Fiscal Association, which in 1961 in Lisbon had already adopted the Van Hoorn approach, confirmed and clarified the intention of their previous resolution in their September 1984 Congress in Buenos Aires: the resolution emphasizes the disadvantages of the principle of worldwide income taxation; it suggests that "a system of territorial taxation or exemption" is preferable and it appeals to legislators in those countries which continue to apply the principle of worldwide income taxation to reconsider this.[92]

2. Distinctions

A preliminary remark may serve to simplify discussion. In discussing the subsequent questions, I learned during a joint seminar with my colleague Otto Gandenberger, three groups of arguments should be distinguished: the economist calls them "allocation policy arguments", "distribution policy arguments" and "finanzausgleichspolitische" (tax sharing policy) arguments.[93] I will attempt to express this in my own words:

- First, arguments that arise from the diverse *economic consequences* relative to particular tax provisions (and an assessment of these consequences).
- Second, arguments that arise from an evaluation of the apportionment of *tax revenues* among the *States* and of *tax burdens* among the *citizens* resulting from those laws: whether they are in accordance with equitable apportionment (iustitia distributiva).
- And, third, arguments that arise from the possible necessity of reapportioning tax revenues according to the requirements of different States.

All three groups of arguments flow into what the lawyer calls "justice" ("Gerechtigkeit"). However, it promotes clarity of thought to distinguish between these three aspects of justice. For purposes of simplification and abbreviation in the following discussion I will limit myself to the arguments of the "middle track", those of equitable apportionment of burdens and revenues. The economic consequences of taxation of foreign income will be discussed by Professor Gandenberger in his subsequent presentation; reapportionment according to particular state requirements can be discussed only with reference to concrete examples.

The arguments of the "middle track" to be considered, as indicated above, include equitable distribution of tax *revenue* among affected countries and equitable distribution of *burdens* among the affected *taxpayers*. In addition, in all discussion regarding the justification of tax measures, three typical forms of argument can be discerned, which I now set out for you:

- The first possibility: taxation is assumed to be a self-evident sacrifice, and only its amount and gradation is considered worth discussing. For this purpose, the general considerations of justice, the principle of equally proportionate sacrifice, as well as social points of view (redistribution) are raised. This form of argument shall be designated the *sacrifice theory argument* or the "sacrifice argument" for short.

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[83] Tipke, *Steuerrecht*, 31 (9th Ed. 1983); K. Vogel, Steuergerechtigkeit und soziale Gestaltung, *Deutsche Steuerzeitung Ausgabe A*, 409, 411 (1975); Birk, note 63, *supra*, at 52.

[84] Valdes Costa, note 75 *supra*.

[85] The general report of the author regarding "The flight from taxation" was delivered orally; its results have been incorporated herein to the extent they relate to the subject of this presentation.

[86] *See* notes 26-28 *supra*.

[87] Flick, *Die Begrenzung der Fiskalsouveränität 71 Internationale Wirtschafts-Briefe*, 131 (1964), *id.*, Folgerungen und Fortentwicklung, in: *Die Besteuerung ausländischer Einkünfte*, note 75, *supra* at 93; Schulze-Brachmann, Totalitäts- oder Territorialitätsprinzip. Ein Beitrag zum Doppelbesteuerungsrecht, *Steuer und Wirtschaft* 589 (1964); Endriss, Ist die Unterscheidung zwischen unbeschränkter und beschränkter Steuerpflicht noch zeitgemäss? *Finanzrundschau*, 338 (1968); *id.*, Wohnsitz- oder Ursprungsprinzip (1967); Tipke, Die Steuerflucht bei internationalen Beziehungen, *Deutsche Landesreferate zum Öffentlichen Recht und Völkerrecht, XI. Internationaler Kongress für Rechtsvergleichung*, 212, 218 (1982); Vogel, Perfektionismus im Steuerrecht, *Steuer und Wirtschaft* 206, 211 (1980); *id.*, Wie geht es weiter? in: *Steueroasen und Aussensteuergesetze, note 42 supra* at 125, 127.

[88] Cmd. 9474 (quoted according to Bühler, *Prinzipien*, 183).

[89] Van Hoorn, Einige Gedanken über die Entwicklung auf dem Gebiet des internationalen Steuerrechts, *Steuer und Wirtschaft* 201, 212 (1960).

[90] CDFI XLVI, 219, 230.

[91] Spitaler, note 74, *supra*, at 444. See for the full text of the Resolution 38 *Bulletin for international fiscal documentation* 12 (1984) at 545.

[92] Bühler, note 74, *supra*, at 183.

[93] Similarly, Richman (now Musgrave), *Taxation of Foreign Investment Income*, 5, 11, 15 (1963) distinguishes between economic efficiency, equity in the tax treatment of investors and equitable international distribution of tax base.

- The second type of argument: taxation is understood as the *consideration* for the public goods guaranteed by the State. This argument may include the attempt to fix the amount of tax in proportion to the value of the guaranteed benefits, but it does not necessarily include it. This traditionally is referred to as the *benefit theory argument,* or the "benefit argument", for short.

Finally, *pragmatic* arguments exist such as the idea that taxation of worldwide income may restrict illegitimate transfer pricing or that it may create pawns for double taxation treaty negotiations. Such pragmatic considerations alone, however, cannot basically justify a tax obligation; they may only affect details. In the field of taxation of foreign income, pragmatic arguments may be discussed to justify, for example, transitional rules, provisions for collection, controls, perhaps retaliatory provisions. Beyond that, pragmatic considerations may induce a state to waive a tax claim, or not to raise it, though it is justified; in this sense (and in this sense alone), Dorn used "state economic allegiance", i.e. the feasibility of ascertaining, determining and enforcing tax claims, as a point to be taken into consideration in negotiating double taxation treaties.[94] Since we are concerned here only with the basis for taxation of foreign income, I shall consider just two of the three types of argumentation, the sacrifice argument and the benefit argument.

3. Taxation of income from capital as an example

a) Weighing the sacrifice argument and the benefit argument

I shall develop this thought first with regard to income generated through use of capital: business income, to the extent it can be traced back to the factor of capital, but also nonbusiness income from invested capital, that is, from "Kapitalvermögen" ("capital assets") within the meaning of the German individual income tax law (§ 20 EStG). This income constitutes foreign income at least where it originates from a foreign permanent establishment, subsidiary or from capital invested abroad; I shall leave aside here all more sophisticated questions of limitation. Whether a tax on such foreign income is justified will be discussed first with regard to the burden on the taxpayer, compared with other burdened or nonburdened parties.

From the point of view of the sacrifice theory, taxation of the foreign capital income in the country of residence – like taxation of foreign income in general – could appear to be justified because foreign income, like domestic income, generates a capacity to pay.[95] Similarly, Spitaler argued that the taxation of worldwide income follows from the income tax being a tax on total income.[96] However, that argument falls short of its goal. Pamela Gann has pointed out, correctly, that the definition of income says nothing about whether the concept encompasses foreign income.[97] Taxation according to ability to pay can mean taxation according to domestic only as well as to domestic and foreign capacity. As mentioned above, principles need to be "concretized"; in this sense, worldwide income taxation and territorial taxation are two plausible interpretations of the ability to pay principle. Even if we could no longer call a tax that was limited to domestic capacity an income tax, the present argument does not turn on the correct name, but on whether it is *more equitable* to extend taxation to foreign capacity.

In favor of including foreign capacity to pay in the domestic tax base, it may be argued that the domestic resident who receives foreign income should be treated the same as a taxpayer who receives a corresponding amount of income from domestic sources, and that the two should be taxed similarly in their country of residence. This argument, however, ignores the fact that the foreign income is produced under different conditions, with a different – generally higher – stake, and subject to different risks than those under which domestic income is produced. Taxation of foreign income according to the law of the country of residence does not take these differences into consideration. Even if double taxation is eliminated by means of a credit, the advantage of a generally lower tax in the country of source, as well as individual tax incentives, will be wiped out by the remaining residence country taxation. Against taxation in the country of residence one can, therefore, with good cause, object that the recipient of foreign income is not to be treated the same as other taxpayers of his country of residence, but rather as other taxpayers of the source country who have generated the same types of income under similar economic conditions. I think both arguments are of equal weight; they therefore cancel each other out.

If no clear conclusion can be reached through application of the sacrifice theory, only the benefit argument remains, as v. Schanz correctly pointed out. To that extent it is significant that the investor investing abroad utilizes the work force, the natural circumstances, the established infrastructure, the legal order and the market of the source country. Not only the businessman uses them, but also, even if less directly, the capital investor. In contrast, the country of residence contributes practically nothing to the production of the foreign income. That it guarantees the security of its citizens and their capital assets abroad cannot be assessed highly today; occurrences in the past few years have drastically demonstrated this. Certainly, the public services of the country of residence are of benefit to the taxpayer in the scope of his private life. This, among other things, led v. Schanz to allow the country of residence with regard to foreign income one quarter of the tax that would be allocated to corresponding types of domestic income.[98] If one argues on the basis of an income tax system alone, that certainly is acceptable. In the Federal Republic,

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[94] *See* note 71 *supra.*

[95] Debatin, Konzeptionen zur Steuerpflicht, *Finanz-Archiv,* 277 (1969); Menck, *Welteinkommen,* note 6 *supra,* at 33; Littmann, *Einkommensteuergesetz,* § 1, Para. 4 (13th Ed. 1981).

[96] Spitaler, note 74, *supra,* at 407. In contrast, Spitaler argues that double taxation conflicts with the principle of equal sacrifice and the principle of capacity to pay.

[97] Gann, note 34 *supra* at 65.

[98] v. Schanz, note 67 *supra.*

however, as in many other countries today, the level of indirect taxation is so high that the services the private citizen receives can be considered discharged through these indirect taxes, especially through the value added tax. Therefore, the benefit argument, too, provides no justification for including foreign investment income in the income tax of the country of residence.

This conclusion is reinforced when one considers the relationship existing between the country of residence and the country of source. The taxation in the country of residence impairs the source country when it forces the taxpayer to withdraw an amount from the source country that is sufficient to cover the tax he is required to pay by the residence country. In this situation sacrifice argument reasons certainly cannot be applied against the country of source. A sacrifice can also be demanded by the source country, without whose economic opportunities the income would not have been generated. It often will need this sacrifice more than the country of residence. The country of residence, however, has not provided a benefit which would have been of advantage to the income that was produced. Against the country of source, the disadvantaged party, therefore, taxation of foreign investment income can in no way be convincingly defended.

b) A fundamental decision is necessary

I shall not be surprised if many are not yet satisfied with my conclusion. As a matter of fact, I have left aside one central assumption; only with this do we reach the actual heart of the problem. Two discernable ways of thinking can be shown to determine the discussion on taxation of foreign income; they are the basis of different legal rules. The divergent standpoints are almost never clearly expressed; however, they determine the results at which both sides arrive.

Let us begin with a consideration in the opinion of the Eberhardt Commission that studied possibilities for tax reform in the late 60s in Germany. The Commission viewed it to be a "weakness" of the exemption method of avoiding double taxation that – in the case of real property – it enables domestic taxpayers "to escape domestic taxation of portions of their property and the income produced therefrom by purchasing real property in a treaty country with a low rate of tax." This result, the Commission argues "lacks justification".[99] Apparently, the Commission bases its argument on the assumption that the country of residence retains a *continuous right* to the income of a domestic taxpayer even after this income has been subject to tax and the tax has been paid. This right survives reinvestment and applies to the profits derived therefrom, whether produced domestically or abroad, and continues to apply to income produced by this income. A sacrifice theory argument, which I have not yet considered, follows from such an assessment: the taxation of foreign income is considered justified because the capital which produced the income was earned originally in the country of residence: what was once property of a nation is always to remain property of that nation.

In contrast to this position, I assumed earlier in this argument that the taxpayer who earned income within his country of residence, who paid the requisite taxes on that income, and who invested the after-tax balance abroad – that this taxpayer, once and for all, has made the sacrifice that he at that point owed to his country of residence, that he paid the consideration he was obliged to pay. A taxation of the profits generated by that capital, domestic or foreign, requires a new justification: either with sacrifice theory or with benefit theory arguments, as we have already discussed them.

Logically, one must concede, both viewpoints are equally conceivable. It is a matter of valuation; two different concepts of State are embodied in them. One valuation is based on the concept of a State which, as soon as it has got its dues, grants its citizens freedom, including the freedom to leave the national territory with their wealth and to use it or enjoy it in another place; the other is based on the idea of a state which clings to its own, which closes itself off, which bases its international tax law only on self-interest. One leads to exchange and international cooperation, the other to isolationism; in the extreme to autarchy. Both valuations are, I must repeat this, conceivable. The German Basic Law, however, prescribes an "open" statehood and international cooperation.[100] Although national egoism and isolationism would not make laws unconstitutional,[101] they fail to meet a goal of the Basic Law.

Other than with the notion of a continuous dominion of a State over "its" capital, the taxation of profits from foreign investment capital cannot be justified, as I have tried to show. If you agree that the right of a State to the income of its citizens is finally discharged by payment of the income tax, there remains no sufficient justification for the taxation of subsequent foreign profits generated through the use of after tax capital.

4. Other types of income tax losses

The conclusion requires completion for income generated from sources other than invested capital and for losses. I can sketch out these questions only briefly.

If we distinguish work, land, capital and know-how as the four factors on which the production of income is based, then what has been established with regard to capital, a fortiori, would apply to work; land cannot be taken into other countries in any case, it can only be purchased anew with capital. A peculiarity, however, exists with regard to know-how, whether it is that of a company, of a professional or of an employee. Know-how is, so to speak, mental capital. Its fundamental existence normally is produced in the country of residence with the support of that country's training institutions, its information opportunities, and its institutions of communication. Unlike the production of monetary capital, the production of this "mental capital" is not

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[99] Gutachten der Steuerreformkommission 1971 (Schriftenreihe des Bundesministeriums der Finanzen, Heft 17) 577. It may be noted that the tax reform commission evaluated the exemption method quite positively.

[100] K. Vogel, Verfassungsentscheidung, note 42, *supra* at 42. Concurring, among others, *see* Tomuschat, Der Verfassungsstaat im Geflecht der internationalen Beziehungen, 36 *Veröffentlichungen der Deutschen Staatsrechtslehrer* 7, 17; Schmidt, op. cit. 65, 66.

[101] K. Vogel, note 100, *supra* at 47.

taxable. Therefore, the country of residence does not receive immediate consideration; its contribution pays out only when the utilization of the know-how produces monetary profits. If this occurs in a foreign country, the home country should be entitled in my opinion to claim a participation in such profits from the taxpayer under both the sacrifice and the benefit theories. The amount of this participation depends on the circumstances. If the use of the know-how in the source country is legally protected – through commercial protective laws or comparable measures – and therefore reserved for the possessor of the know-how, then the profits generated are based primarily in the law of the source country. In contrast, if general know-how is involved, which everyone is free to develop, then I would value the contributions of both countries approximately equally.

On the other hand: to what extent general or protected know-how already has been used in the country of residence, that is, to what extent it has already produced taxable profits, in my opinion should be considered irrelevant. The value of "mental capital" can be determined only according to the amount of profit which can be or has been produced through the use of this type of capital. Moreover, the country of residence can be limited no more than the country of source in its ability to tax according to the measure of its contribution to the production of the know-how. The benefit argument justifies both claims to taxation in principle; to determine the amount of the tax, sacrifice theory arguments remain applicable. I understand, but cannot follow, therefore, one argument, which is often espoused by speakers from developing countries: that taxation of foreign royalty income in the country of residence is not justified if the intangible property right or know-how has already been written off there. A waiver of taxation of such income in favor of developing countries often will be advisable as a matter of "tax sharing policy" or "fiscal equality policy". "Distribution policy", that is the concept of equitable distribution, does not automatically lead to such a waiver; but this obviously does not prevent the country of residence from waiving a justifiable tax claim out of other economic considerations.

Finally, that sacrifice theory arguments remain applicable in determining the amount of taxation also holds true with regard to the progressivity of the tax system and for the treatment of losses. Even where including an item of foreign income in the residence country's tax base cannot be justified, it remains sensible and just to make allowance for such items in determining a progressive tax rate applicable to domestic income. Similarly, it may be necessary to make an allowance for foreign losses, at least to the extent to which other losses that lie outside the sphere of taxable income are also taken into consideration, as are extraordinary burdens under German law. Therefore, I still consider the best solution to be the legislative recommendation of the Federal Government from 1969, which would allow losses even with respect to tax exempt income to be generally deductible – with the obligation to recapture the losses allowed in the case of subsequent profits in the State granting the exemption.[102] To avoid misunderstandings: taxation according to territoriality, and this cannot be over-emphasized, does not mean that foreign facts simply may not be taken into consideration. Territoriality is not incompatible with recognition of foreign income in so far as progressivity, foreign realization events, foreign expenses or the credit of foreign taxes are concerned. Our purpose is not to arrive at pure realization of a dogma; it is to derive equitable solutions to individual questions from a consistent premise.

In summary: what I have attempted to develop for you can, of course, only be a sketch of the main features of a system of just international taxation. It should be apparent that what I have suggested here by no means will solve all of the problems of international tax law. We shall continue to be confronted with the task of determining the items of income that are to be understood as "domestic"; we shall continue to be confronted with the difficult task of limiting the types of income that are to be associated with particular sources; we must clarify the problem of losses. However, we would possess a system of international tax law whose fundamental principle would be clear, whose solutions would be uncontradictory and, to that extent, obvious, and whose test questions which arise could be answered by further development of its basic notions. That would be at least a step in the right direction.

ANNEX 1

Incorporation of the Foreign Tax Law within the Personal Income Tax Law – A suggestion

Short version:

1. § 2 (1) EStG is amended to add:
   "(1a) Also subject to the income tax shall be the additional amount calculated pursuant to §§ 7 – 14 AStG."
2. § 2 (2) EStG is amended to add:
   "(2a) Income from trade relations with foreign persons is calculated according to the provisions of § 1 AStG."

Detailed version:

1. § 2 (1) EStG is amended to add:
   "(1a) Also subject to the income tax shall be, with respect to a taxpayer who is subject to unlimited tax liability, an additional amount equal to such taxpayer's proportionate share of the income of a foreign corporation (§ 7 (1) AStG) that constitutes a base corporation with respect to such taxpayer (§ 8 AStG). The taxpayer's share shall be determined according to §§ 7 and 9 AStG. The additional amount shall be reduced by amounts actually distributed to the taxpayer by the corporation; it shall be treated for income tax purposes as it would if the corporation had made an actual distribution to the taxpayer."

   To § 2 (2) the following sentence shall be added:
   "The additional amount subject to income tax under para. 1a shall be calculated according to the provisions of §§ 10 *et seq.* AStG."
2. (Same as above)

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[102] Entwurf eines Gesetzes über die Gewährung von Investitionszulagen und zur Änderung steuerrechtlicher und prämienrechtlicher Vorschriften (Zweites Steueränderungsgesetz 1969), Art. 2 Nr. 1 Bundestagsdrucksache V/3890.

ANNEX 2

Prejudicial income under § 8 AStG

I. Passive income

1. Loans of capital, unless:
   borrowed solely in foreign capital markets and applied, long-term, to permanent establishments engaged in an active trade or business abroad.
2. Equity capital holdings, unless:
   the subsidiary corporation is resident in the same country as the distributing corporation and is itself engaged in an active trade or business ("Landesholding"), or
   the investment of the subsidiary corporation in the distributing corporation is economically connected with the active conduct of trade or business of the subsidiary corporation and the distributing corporation is itself engaged in an active trade or business ("Funktionsholding").
3. Lease or rental of rights or know-how, if:
   it does not involve the product of its own research and development.
4. Lease or rental of real property, unless:
   the income also would be exempt according to the provisions of a double tax treaty if it were realized directly by the controlling shareholders.

II. "Income susceptible to manipulation"

1. Credit institutes or insurance companies if they:
   do not maintain an established business facility (that participates in general economic intercourse)
   or transact business primarily with controlling shareholders (more precisely, shareholders that satisfy the requirements of § 7 AStG) or persons related to them
2. Trade, if a controlling shareholder or related person is the supplier or the purchaser, and . . .
3. Services, if they are performed by or for the controlling shareholder or a person related to him, and . . .
4. Lease or rental of personal property, if the controlling shareholder or a person related to him participates in the activity, and . . .

} no established business facility which participates in general economic intercourse is maintained.

DISCLOSURE TO THE TAX AUTHORITIES
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FEDERAL REPUBLIC OF GERMANY:

Selected Problems of International Tax Law

Meeting of the German Tax Law Association

By W.G. Kuiper

On 8 and 9 October 1984, the German Tax Law Association (Deutsche Steuerjuristische Gesellschaft) held its annual meeting in Heidelberg. The subject of this meeting was "Basic problems of international tax" (Grundfragen des internationalen Steuerrechts). During these 2 days a number of lectures were given by distinguished German tax experts, all of whom dealt with a specific aspect of international tax law in relation to the Federal Republic of Germany. The lectures given on the first day mainly concentrated on a number of international tax aspects contained in German domestic law, whereas the lectures on the second day dealt with a number of specific tax problems resulting from treaty provisions, particularly the question how and in which cases treaty rights and protection can be influenced, either by action of the taxpayer or by the tax authorities.

The first lecture was given by Prof. Dr. Klaus Vogel from Munich, who discussed the principles and practice in Germany concerning the taxation of foreign-source income. An English version of his lecture is published on page 4 of this issue.

In the second lecture, Prof. Dr. Otto Gandenberger, an economist from Munich, discussed the influence of the German individual and corporate income tax on the international flow of investment and capital. Dr. Gandenberger argued that, ideally, there should be international tax neutrality. However, domestic tax laws often bring about international tax non-neutrality (at least to a certain extent). As far as Germany is concerned, there are four areas which have an impact on international neutrality (or non-neutrality) of individual and corporate income tax law, i.e.:

(1) provisions which give rise to double taxation;
(2) provisions concerning the avoidance of double taxation;
(3) special provisions in the corporate income tax law concerning credits and exemptions which are (or were) only granted to resident taxpayers; and
(4) withholding taxes.

Dr. Gandenberger pointed out that, as far as the avoidance of double taxation of profits from direct foreign investment is concerned, there is a notable difference between the credit method and the exemption method in terms of international tax neutrality. In this respect, a distinction should be made between two manifestations of "neutrality", i.e. capital export neutrality (meaning equal tax treatment of all investments made by the residents of a country outside the country) and capital import neutrality (meaning equal tax treatment of investments already made or under consideration by different countries into the taxing country). Dr. Gandenberger pointed out that the credit method usually leads to capital export neutrality (but to non-neutrality in the source-State), whereas the exemption method usually leads to capital import neutrality (but to non-neutrality in the State of residence).

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In his lecture, Dr. Gandenberger also discussed a number of other provisions in German income tax law which have a "directional effect" on direct foreign investment, i.e. which result in non-neutrality. In particular, he mentioned the fact that German corporate income tax is not a pure profits tax but, from an economic point of view, also has the nature of a "cost-based" tax because of a higher tax burden on non-distributed profits and the element of lost interest on invested capital contained therein. Dr. Gandenberger concluded that the exemption method should be preferred in case of profits from direct foreign investment, even when distributed. However, it should be combined with a strict allocation of the taxing power of the states concerned following the territoriality principle. Only in the case of interest and royalties would the application of the credit method be sufficient.

The third lecture by Dr. Franz Wassermeyer, a judge at the German Supreme Tax Court in Munich, dealt with some specific problems concerning the liability of non-residents to German tax ("beschränkte Steuerpflicht" or limited tax liability). After an historical overview, in which it was explained that the original goal of the limited tax liability was the avoidance of double taxation, Dr. Wassermeyer argued that there are many inequalities in the tax treatment of residents and non-residents, both as regards the tax base and the applicable tax rates. In the opinion of the speaker, the limited tax liability in Germany should be measured in relation to the principle of tax equality and earning power (Leistungsfähigkeit) of the taxpayer, while also taking into account the tax assessed abroad. If this would still lead to inequalities, these should be eliminated by applying the provisions in German law concerning avoidance of hardship, a matter to be taken up by the German Legislature. Finally, Dr. Wassermeyer argued that the "extended limited tax liability" which applies under the German Foreign Tax Law (Aussensteuergesetz) also leads to tax inequality and, perhaps, to violation of the Constitution. In his opinion, it would have been better if the legislature had tried to eliminate the weak points of the limited tax liability in cases of tax evasion by introducing some general adjustments into German individual and corporate income tax law.

The next subject discussed was entitled "Taking into consideration losses in the case of foreign-source income" by Dr. Helmut Krabbe, a Regierungsdirektor at the German Federal Ministry of Finance in Bonn. Dr. Krabbe pointed out that, as a general rule, positive and negative income obtained in one tax year may be set off against each other under German tax law. One of the most important exceptions to this rule is Sec. 2a of the Individual Income Tax Law which was introduced in 1982. According to this provision, the possibility of setting off foreign-source losses against German-source income is considerably limited. However, there is not only this limitation under German domestic law, but also, as a result of case law, under tax treaties which provide for an exemption as the method for the avoidance of double taxation: in such cases, not only "positive", but also "negative" foreign-source income must be excluded from the German taxable base. On the other hand, "negative" foreign-source income can lead to a reduced German income tax rate, if the exemption-with-progression rule is applied under tax treaties, in other words, "negative" foreign-source income mitigates the progression of German income tax rates. Dr. Krabbe pointed out the provision of Sec. 2 of the Law on Foreign Investments in which this disadvantageous tax treatment of foreign-source losses under tax treaties may be set aside upon request, however, only as far as it concerns losses incurred from a foreign permanent establishment. Dr. Krabbe questioned whether the provision of Sec. 2 of the Law on Foreign Investment still makes sense after the introduction of Sec. 2a of the Individual Income Tax Law and he suggested that future legislation would allow the setting off of foreign-source losses in the case of tax-exempt income, as far as the losses qualify for a carry-forward in the State of source and later taxation of income is guaranteed.

Dr. Krabbe, thereupon, turned to a more detailed discussion of Sec. 2a of the Individual Income Tax Law, in which foreign-source losses from forestry, agricultural and business activities (through a foreign permanent establishment, not being an "active undertaking"), from foreign silent participation and foreign-situs real property can only be set off, for purposes of German taxation, against positive income from the same source in the same country in the next 7 assessment years. The provision must be considered as an exception to both Sec. 2 of the Individual Income Tax Law (which, inter alia, provides for liability to German taxation on worldwide income) and Sec. 10d of the same law (which contains the general provisions concerning loss compensation). The provision has widely met with much opposition, because it was felt to be in conflict with the general system of German income tax law. Moreover, the effects of the new provision on the application of the foreign tax credit and the exemption with progression, as contained in German income tax law, are heavily contested. On the other hand, Dr. Krabbe pointed out that the new provision as such is not *in conflict with* the German provisions concerning the foreign tax credit and the exemption-with-progression (because a provision of domestic law can always be overruled by a later provision), nor with treaty provisions (because the treaties do not contain provisions concerning loss compensation). On the other hand, Dr. Krabbe did not deny that it would be useful to re-examine the implication of Sec. 2a of the Individual Income Tax Law and, perhaps, to introduce new legislation concerning the tax treatment of foreign-source losses.

After Dr. Krabbe, Mr. Ritter, a tax manager at BASF, took the floor. Mr. Ritter gave a lecture on the subject "The burden of proof and presumption rules in the case of intercompany pricing". This subject is of particular current interest, because no explicit provisions thereon are contained in the directives on intercompany pricing issued by the Federal Ministry of Finance in early 1983. In general, the tax authorities bear the burden of proof for facts which substantiate a tax claim. However, the taxpayer bears the burden of proof in cases of a tax exemption or tax relief. In respect of business expenses, the tax authorities bear the burden of proof for each asserted increase of income. However, the taxpayer bears the burden of proof for each increase of expenses to be deducted. This distinction may give rise to problems in the case of hidden profit distributions which are characterized by both elements. In general, however, it is believed that the tax administration has the burden of proof. The same applies to alleged abuses of law. A survey of case law indicates, however, that in the case of deductible business expenses, the burden of proof generally rests with the taxpayer, even if the opposite would have been expected. Mr. Ritter pointed out that this case law can, at the least, be considered confusing. However, for the area of intercompany pricing, the following could be concluded from the case law: an alleged increase of profits should be proved by the tax administration, otherwise, proof must be delivered by the taxpayer. Having established this, it is surprising that the directives on intercompany pricing implicitly transfer the burden of proof to the enterprises involved. Mr. Ritter then drew attention to a number of exceptions from the general rule, i.e. where there is a transfer of the burden of proof from the tax administration to the taxpayer, or where there is an increased obligation of the taxpayer to cooperate with the tax administration and to supply additional information. This leads to highly confusing and complicated situations in practice, particularly in the case of border-crossing transactions, and the directives on intercompany pricing even worsen these complications. Mr. Ritter reasoned that, in the area of intercompany pricing, the general presumption that the information supplied by the taxpayer is correct should be applied and this should not automatically give rise to suspicion by the tax administration. Therefore, it should not be the task of tax auditors to question the correctness of the transfer prices and to require the taxpayer to prove this correctness, while at the same time appealing to his duty to cooperate with the tax administration. However, even if the taxpayer has complied with his duty to cooperate and the tax administration has the burden of proof, if it is not convinced of the correctness of the transfer prices, there are certain cases in which the burden of proof for the tax administration is further reduced. These cases were critically discussed by Mr. Ritter, particularly in so far as they concerned cases in which a presumption of fraud is assumed by the tax administration and which must then be rebutted by the taxpayer. In sum, Mr. Ritter pointed out that there are many uncertainties and confusing aspects concerning the question with whom the burden of proof with respect to transfer prices rests. Moreover, the directives on intercompany pricing violate current legal rules concerning the burden of proof in many respects. Therefore, Mr. Ritter argued that a critical review and a revision of these directives is needed within the very near future.

The first lecture on the second day was given by Prof. Dr. Jörg Mössner from Osnabrück who dealt with the preferences, the (dis)advantages and the current practical problems of the various methods for the avoidance of double taxation. Prof. Mössner defined the concept of "avoidance of double taxation" as the creation of tax neutrality between two or more States, *not* as the elimination of conflicting norms and allocation rules in the various States (because this is not a *method* for the avoidance of double taxation). Thereupon, Prof. Mössner discussed the various existing methods for the avoidance of double taxation, particularly the exemption method, the credit method, reduced tax rates and the deduction method, as well as the effects thereof on the tax burden in Germany. As regards the exemption method, he stated that this should be interpreted as a real tax exemption (i.e. a "not-taking-into-account" of taxable items) and not as an allocation of taxable items. More specifically, the exemption with progression should be considered as an infringement of the exemption principle which does not create full tax neutrality. The various methods lead to particular disadvantages in the case of domestic or foreign-source losses. Under the exemption method, foreign-source losses are not really excluded from the taxable base, but they may be taken into account for the determination of the applicable tax rate. In the case of foreign-source "positive" income and domestic-source losses, both the exemption method and the credit method lead to the result that the foreign tax is not fully taken into account in avoiding double taxation. Similar problems may arise in the case of investment incentives and high deductible business expenses. Neither German unilateral relief nor the tax treaties concluded by Germany contain provisions for a sufficient and satisfactory solution to the problems which arise in this respect.

The topic of the following lecture, by Mr. Helmut Becker, a lawyer and tax advisor from Düsseldorf, was "Treaty shopping". Mr. Becker defined the concept as the use (not: abuse) of treaty protection by interposing a person who can claim such treaty protection which would not have been available otherwise. Normally, there is a triangular situation, e.g. the relationship of a company in Country A to a company in country B through an interposed company in country C, for example because there is a treaty between B and C and no treaty between A and C. However, such a triangular situation is not always necessary for treaty shopping (e.g. in the case of the so-called "Quintett-situation"[1]). A relatively new form of treaty shopping are the "stepping-stone" companies: the interposed company is not entitled to a specific incentive in a treaty country, but its profits are taxed at a low rate in that country (e.g. interest, commission fees), whereas the relevant expenses are deductible in the high-tax country. Mr. Becker discussed the developments with respect to treaty shopping in the United States and the combat thereof, inter alia, by including special provisions in the various treaties under which certain persons or profits are excluded from treaty relief; special attention was drawn to Art. 16 of the U.S. Model Convention and to a number of U.S. Court cases. Thereupon, Mr. Becker discussed the phenomenon of treaty shopping in German law and literature. He concluded that little was written about the subject in Germany. First, he discussed a number of German Court cases with respect to the "Quintett-situation" and the response thereto of the German tax administration. Thereafter, he discussed a number of provisions in the German-Swiss tax treaty (particularly Arts. 4 and 23) which can be considered as measures against treaty shopping, because, in the opinion of the German tax administration, these provisions prohibit the claiming of treaty relief by persons who do not benefit from the protection granted by the treaty in general. Mr. Becker contested this, because these provisions concern the use of treaty provisions by the taxpayer himself, not by an intermediary. There are several other treaties concluded by Germany which contain similar provisions. In this respect Mr. Becker also referred to the provisions concerning the so-called "artist companies" as contained in Art. 17 of the OECD Model Convention and to the proposed legislation in Germany concerning the taxation of artists. Mr. Becker also stated that the additional taxation (Hinzurechnungsbesteuerung) of foreign base companies under the Foreign Tax Law (Aussensteuergesetz) should not be considered as measures against treaty shopping but as "corporation shopping". However, although the "additional taxation" as such has nothing to do with the subject discussed, there are certain related elements in it, because, in the reverse case, states can also evade the provisions of tax treaties, e.g. by introducing laws which are aimed at avoiding disadvantageous consequences but which do not correspond with the actual contents of a treaty. As examples thereof, Mr. Becker mentioned:

(1) the refusal by Germany to grant the imputation tax credit under tax treaties; and

(2) the proposed German legislation concerning this capitalization.

Thereupon, Mr. Becker examined to what extent the German courts have dealt with the matter of treaty shopping. Apart from the above cases concerning the "Quintett-situation", Mr. Becker particularly mentioned the "Monaco" case, which in his opinion was a typical case of treaty shopping. In its decision of 29 October 1981, the First Chamber of the German Supreme Tax Court held that the formation of a Swiss company by a resident of Monaco in order to make use of the provisions of the German–Swiss tax treaty was not an abuse of law. In spite of a later decision of the Fourth Chamber of the Supreme Tax Court, in which a case of "corporation shopping" was not to be allowed, Mr. Becker's general conclusion was that treaty shopping is permissible under German law, because, in the words of the Supreme Tax Court, the use of existing legal possibilities to reduce the tax burden cannot be regarded as an abuse of law. In the light of the existing anti-evasion legislation, Mr. Becker found this statement somewhat surprising. Therefore, the question arises where to

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[1] Judgment of the Supreme Tax Court of 19 February 1976, No. 1R 26/73 published in *II Bundessteuerblatt* 584 of 15 August 1975. For an analysis of the case see 15 *European Taxation* (1975) at 276.

draw the line between "legal" treaty shopping and "illegal" tax evasion. In this respect, the decisive criterion is that treaties generally apply to residents of one or both Contracting States (i.e. that they are subject to tax in that country on world-wide income and property), regardless whether this tax in the other Contracting State is assessed at high or low rates and whether a person in the other Contracting State is controlled by a person in a third country. When negotiating tax treaties, the authorities are normally well informed about the tax system of a country and the possibilities to reduce the tax burden. These considerations also apply to legal entities resident in the other State. Therefore, Mr. Becker argued that the Statement that treaty shopping is improper (unangemessen) is not correct, and, thus, that treaty shopping is not an abuse of law.

The next speaker, Dr. Klaus Manke from the Federal Ministry of Finance in Bonn, dealt with the subject of to what extent partnerships are entitled to treaty protection and the problems in this respect. Dr. Manke defined a partnership as a company the partners of which are regarded as co-entrepreneurs. According to German tax law, the partners are separately subject to income tax on their share in the profits. However, under tax treaties with other countries there are two possibilities, as far as taxation in the other country is concerned:

(1) the partnership is treated in the same way as in Germany; or

(2) the partnership is regarded as a legal entity and taxed as such (i.e. the individual partners are not subject to tax).

This can lead to a number of questions concerning the tax treatment of partnerships in international situations. Dr. Manke particularly mentioned the following:

- a German partnership derives income from a permanent establishment in the other treaty country or a third State, whereas one or more of the partners is a resident of that other treaty country or third State,
- a partnership in the other treaty country derives income from a permanent establishment in Germany in a third State, whereas one or more of the partners is a resident of Germany or a third State.

Dr. Manke argued that the OECD Model Convention does not solve the problems which arise in this respect. He explained this in more detail on the basis of the provisions of the new tax treaty between Germany and Canada. Thereupon, Dr. Manke discussed a number of treaties concluded by Germany which contain special provisions in this respect, e.g. the German–Swiss tax treaty (Arts. 7(7) and 24(1)(3)), the German–Spanish tax treaty (Arts. 4(4), 10(4) and 23(1)(a)) and the German–Belgian tax treaty (Arts. 4(1), 10(5)(1) and 23(1)). Dr. Manke concluded that the international tax problems with respect to partnerships are insufficiently resolved under the German–Canadian and the German–Swiss tax treaties. The treaties with Spain and Belgium offer better protection. However, it appeared to him that the new treaty between Germany and Sweden which is currently being negotiated and which will presumably contain a separate article on the taxation of partnerships will offer the best solution for these problems.

The following topic discussed concerned the qualification problems of current interest in determining whether to establish a partnership or a corporation. This subject was discussed by Dr. Egon Schlütter, a lawyer and tax advisor from Cologne. Dr. Schlütter pointed out that the qualification of a partnership according to the civil law or the tax law of another country is not decisive for purposes of tax treatment in Germany. This also normally applies in the reverse case, for example, according to U.S. law, a German "GmbH & Co KG" is usually regarded as a corporation (in Germany, it is considered a limited partnership). Dr. Schlütter discussed the many problems which arise in this respect, e.g. the question regarding the treatment of interest on loans granted by partners, and the treatment of special remunerations to partners, and he concluded that there is insufficient protection offered by tax treaties in this respect.

The last subject of the meeting was discussed by Dr. Widmann, a judge at the Supreme Tax Court in Munich. It concerned whether and to what extent tax treaties have an impact on national law and the changes therein. The qualification of certain concepts or certain types of income may be influenced by case law, by treaties and by changes in national law. As far as treaties are concerned, Dr. Widmann referred to Art. 3(2) of the OECD Model Convention which contains a provision on the question of which law should be applied in the case of concepts or certain income items not defined by the treaty. Following a resolution of the IFA Congress in Basel, Dr. Widmann pointed out that one has to be careful in applying Art. 3(2) of the OECD Model Convention and similar provisions in bilateral treaties, as this can easily lead to double taxation. As far as changes in national law are concerned, Dr. Widmann referred to an illustrative decision of the Canadian Supreme Tax Court with respect to the German–Canadian tax treaty (the so-called Melford Case). In this decision, the Court held that Art. 2(2) of the treaty (which may be compared with Art. 3(2) of the OECD Model Convention) was applicable, but only to such concepts, types of income and taxes which existed at the time of conclusion of the treaty. See in this respect 37 *Bulletin for international fiscal documentation* 11 (1983) at 493. Thereupon, Dr. Widmann mentioned a number of (planned) changes in German tax law (e.g. the provisions on the winding up of a German corporation under the Corporate Income Tax Law, the planned provision on thin capitalization) and he examined to what extent these have an impact on the application and interpretation of tax treaties as well as whether the mutual agreement procedure under tax treaties could play a role in solving these problems.

In sum, one can say that this conference, which was excellently organized, provided a valuable contribution to international tax law, not only from a German point of view, but particularly because a number of the issues raised and the solutions proposed deserve to receive wider attention. However, it remains to be seen whether and when these issues (and the solutions thereto) will be followed up in practice, e.g. by legislative action.

UNITED STATES:

Basic Principles Affecting the Income Taxation of Foreign Persons

By Piroska E. Soos

I. INTRODUCTION

The provisions of the United States Internal Revenue Code[1] ("IRC") dealing with the income taxation of non-resident aliens and foreign corporations distinguish between those that are not engaged in a trade or business within the U.S. and those that are. The former are generally subject to tax at a flat rate (30% or lower treaty rate) on the gross amount of the types of U.S.-source income specified in the IRC; income not so specified and certain capital gains are exempt from tax.

The situation with regard to foreign persons (i.e. non-resident aliens and foreign corporations) engaged in business in the U.S. is different. Prior to 1966, such persons were subject to tax on *all* their (net) U.S.-source income at the progressive rates applicable to U.S. citizens and residents and to domestic corporations. No distinction was made between the foreign person's business income and other unrelated income, such as investment income. This tax regime was based on the "force of attraction" principle pursuant to which *all* of the U.S.-source income of a foreign person engaged in business in the U.S. was deemed "attracted" to that business and taxed as business income. Accordingly, certain items of non-business income which would otherwise have been exempt from tax were no longer exempt.

The Fowler Task Force[2] submitted its report in 1964 in which it found that the "force of attraction" principle deterred foreign persons from simultaneously engaging in business in the U.S. and becoming investors there. At least partly as a result of this finding, the Foreign Investors Tax Act of 1966[3] generally abandoned the "force of attraction" principle and introduced the concept of "income effectively connected with the conduct of a trade or business within the U.S.". Only the "effectively connected" income was subject to tax at the regu-

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[1] The United States Internal Revenue Code of 1954, as amended.

[2] The Fowler Task Force was appointed by former U.S. President Kennedy in 1963 to develop programs to promote foreign investment in U.S. companies and otherwise to attract foreign capital to the U.S. The Task Force recommended that the regular U.S. income tax rates be applied only to the business-related income of foreign persons engaged in business in the U.S. See Jones, "Foreign Investors Tax Act – The "Effectively Connected" Concept and Taxation of Domestic Source Income", 26 *N.Y. Univ. Institute on Federal Taxation* 389 (1968), reprinted in part in Owens, E.A., *International Aspects of U.S. Income Taxation – Part II: Taxation of Nonresident Aliens and Foreign Corporations on U.S. Source Income*, Harvard Law School International Tax Program, Cambridge, Massachusetts 1980, at 131, 135-36. This latter publication is hereinafter cited as "Owens".

[3] Public Law 89-809.

lar U.S. income tax rates; other income was taxed in the same manner as in the hands of a foreign person not engaged in business in the U.S. However, the "force of attraction" principle was retained to a limited extent (see Section IV.B.).

This article examines the basic principles relating to the U.S. federal income taxation of non-resident aliens and foreign corporations in the absence of a treaty. The general outline established by the Foreign Investors Tax Act of 1966 remains intact, although there have been important changes, such as those made by the Foreign Investment in Real Property Tax Act of 1980[4] which introduced special rules applicable to "U.S. real property interests". Most recently, the Tax Reform Act of 1984[5] made important changes by, for example, providing a statutory definition of "resident" and" non-resident" alien, repealing the 30% tax with regard to certain U.S.-source interest, and imposing withholding requirements in connection with the disposition of "U.S. real property interests".

II. DEFINITION OF "NON-RESIDENT ALIEN" AND "FOREIGN CORPORATION"

The taxpayer's status as a "resident" or "non-resident" alien or as a "domestic" or "foreign" corporation determines whether he/it is subject to unlimited (world-wide income) or limited (U.S.-source income) taxation in the U.S. In addition, the taxpayer's status may have important tax consequences for the entities in which the taxpayer invests as well as for other investors in such entities.[6]

A. Non-resident aliens

1. Rules applicable through 1984

Prior to the Tax Reform Act of 1984, the definition of "resident" and "non-resident" alien was in the IRC Regulations ("Regs.") rather than in the IRC itself. Reg. 1.871-2(a) defines "non-resident alien" as an individual whose residence is not in the U.S. and who is not a U.S. citizen. Reg. 1.871-2(b) states that a "U.S. resident" is an alien actually present in the U.S. who is not a mere "transient" or "sojourner" and further provides:

> Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

The other Regulations relating to residence focus on the nature and duration of an alien's stay in the U.S. and his intentions regarding such stay. Reg. 1.871-4 establishes that an alien is, by reason of his alienage, presumed to be a non-resident, but this presumption may be rebutted by, for example, an alien's filing a declaration of his intention to become a U.S. citizen or his acts or statements showing a definite intention to acquire residence in the U.S. or showing that his stay in the U.S. has been of such an extended nature as to make him a resident. In addition, the U.S. Internal Revenue Service ("IRS") has ruled that an alien who has been present in the U.S. for as much as one year is presumed to be a resident for tax purposes, but such a stay does not establish residence beyond a reasonable doubt.[7]

The subjective approach taken in the Regulations requires a case-by-case examination of all the facts relating to an alien's stay in the U.S., and the conclusion reached in a particular case may not offer much guidance to other aliens. For example, an alien author who had remained in the U.S. for almost 4 years by extending his temporary visa was held to be non-resident because he had intended a limited stay in the U.S., had lived in a hotel during the entire time, and had not obtained a regular job or engaged in business in the U.S.[8]

The many Revenue Rulings and court decisions regarding "residence" suggest that there is significant uncertainty in this area. The present law, with its presumptions and rebuttals and its heavy reliance on the alien's intentions, makes it difficult to determine an alien's residency status.[9]

2. New rules effective after 1984

The Tax Reform Act of 1984 added IRC, Sec. 7701(b) which defines the terms "resident alien" and "non-resident alien" and provides more objective criteria for determining residence than exist under present law. The new definition applies only for purposes of the U.S. income tax (not for purposes of the U.S. estate and gift tax) and is generally effective for tax years beginning

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[4] Public Law 96-499.

[5] Public Law 98-369.

[6] For example, the terms "controlled foreign corporation" and "foreign personal holding company" are both defined, in part, by reference to the shareholdings of persons that are U.S. citizens or residents or domestic corporations (IRC, Secs. 951, 957, 552). Classification as a "controlled foreign corporation" under "Subpart F" of the IRC (i.e. IRC, Secs. 951-964) or as a "foreign personal holding company" (see IRC, Secs. 551-558) means, among other things, that the U.S. shareholders may be subject to tax with regard to their share of the foreign corporation's undistributed profits. These rules are designed to prevent tax avoidance by U.S. shareholders who might try to use foreign corporations in low tax countries to accumulate income.

[7] Revenue Ruling 69-611, 1969-2 Cumulative Bulletin 150.

[8] *Ferenc Molnar,* 4 Tax Court Memoranda 951, affirmed on other grounds, 156 F.2d 924 (2d Cir. 1946). See also *Tongsun Park v. Commissioner* (79 U.S. Tax Court Reports 252 (1982)) in which the Court, in an opinion almost 50 pages long, conducted an extensive inquiry into the taxpayer's presence in the U.S. over a period of approximately 20 years before the Court concluded that the taxpayer was a U.S. resident for tax purposes for the years 1972-1975.

[9] New York State Bar Association Tax Section Committee on U.S. Activities of Foreign Taxpayers, "Report on the Definition of "Resident" in Section 451 of the Tax Reform Bill of 1983 (H.R. 4170, the "Bill")", *The International Tax Journal,* Vol. 10, No. 3 of March 1984 (hereinafter "N.Y. Bar Asso.") at 173, 176.

after 31 December 1984. However, the existing definition of "resident" will continue to be relevant for a transitional period in that the pre-1985 presence in the U.S. of an alien who is not a resident under present law at the close of 1984 will not count in applying the "substantial presence" test (see below) and the pre-1984 presence of an alien will count only if he was a resident under present law at the end of both 1983 and 1984.[10]

According to IRC, Sec. 7701(b), a "resident alien" is an alien who is a resident of the U.S. under either the "permanent residence" test or the "substantial presence" test, and a "non-resident alien" is an alien who is not a U.S. resident under either test. An alien satisfies the "permanent residence" test if he is a "lawful permanent resident" of the U.S., meaning that he has the status of having been lawfully granted the privilege of residing in the U.S. as an immigrant and that this status has not been revoked or administratively or judicially determined to have been abandoned. No minimum presence in the U.S. is required for treatment as a resident under this test.

The "substantial presence" test is satisfied if an alien is present in the U.S. for more than 31 days during the current year and has been present in the U.S. for 183 days or more during a 3-year period including the current year. In counting the 183 days, each day in the current year is considered as one full day, each day in the first preceding year as one-third day, and each day in the second preceding year as one-sixth day. An individual is generally considered as being present in the U.S. on any day on which he is physically present in the U.S. for any amount of time, but not on any day on which he is:

(i) an "exempt individual", i.e. a foreign government-related individual or a teacher, trainee or student;[11]
(ii) unable to leave the U.S. because of a medical condition which arose while he was present in the U.S. (e.g. a serious automobile accident shortly before a planned departure);
(iii) physically present in the U.S. for less than 24 hours while in transit between two points outside the U.S.; or
(iv) at his place of employment in the U.S. to which he regularly commutes from his residence in Mexico or Canada.

An alien who satisfies the "substantial presence" test may, nevertheless, be treated as a non-resident under the "closer connection/tax home" exception which is available only if he (a) is present in the U.S. for fewer than 183 days in the current year and (b) has not filed an application, or taken other steps, to change his status to that of a permanent resident of the U.S. In order to qualify as a non-resident under this exception, the alien must establish that his "tax home" (i.e. regular or principal place of business or employment)[12] is in a foreign country and that he has a "closer connection"[13] to such country than to the U.S. The maintenance of an abode in the U.S. will not automatically prevent an individual from establishing a tax home in a foreign country.[14]

"Residence" is determined on a calendar year basis, and an alien who was a resident during the preceding year and is a U.S. resident for the current year continues to be taxable as a resident at the beginning of the current year, i.e. residence for tax purposes does not lapse but continues throughout both years.[15] IRC, Sec. 7701(b)(2) contains special rules regarding an alien's first and last years of residency,[16] the effect of which is that an alien whose residency status changes during the calendar year is taxed as a resident only for the portion of the year during which is a resident.

Recognizing that the new definition may conflict with the provisions regarding residence in tax treaties concluded by the U.S., the legislative history states that it is not intended that the new definition override treaty obligations.[17] Thus, in case of conflict, the treaty definition will prevail.

B. Foreign corporations

In distinguishing between domestic and foreign corporations, U.S. tax law uses the "place of incorporation"

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[10] U.S. House of Representatives Committee Report on the Tax Reform Act of 1984, reprinted in *CCH Federal Tax Guide Reports*, No. 42 of 20 July 1984 (hereinafter "House Report") at 904, 908.

[11] The terms "foreign government-related individual", "teacher", "trainee", and "student" are defined in IRC, Sec. 7701(b)(4)(B), (C), and (D); IRC, Sec. 7701(b)(4)(E) indicates when these aliens do not qualify as "exempt individuals".

[12] "Tax home" is a concept used in IRC, Sec. 162(a)(2) which allows a deduction for travelling expenses while away from "home" in the pursuit of a trade or business. "Home" has been interpreted as the taxpayer's "tax home", thus denying a deduction for the cost of commuting from the taxpayer's residence to his place of business or employment but allowing a deduction for costs incurred for travelling between two places of business or employment.

[13] IRC, Sec. 7701(b) does not define "closer connection". However, it has been suggested that this concept is related to the phrase "resident of the State with which his or her personal and economic relations are closer (center of vital interests)" in Art. 4(2)(a) (dealing with residence) of the U.S. Model Income Tax Treaty of 17 May 1977 and in Art. 4 of the 1977 OECD Model Convention. See N.Y. Bar Asso. (note 9) at 183.

[14] House Report (note 10) at 905.

[15] House Report (note 10) at 906. As examples, the House Report states that an alien who is present in the U.S. from 1 January to 1 August 1985 and from 1 June to 31 December 1986 will be a U.S. resident for all of 1985 and 1986. Similarly, an alien who is in the U.S. for 7 months in 1985, leaves before the end of 1985, returns on 1 December 1986, and becomes a lawful permanent resident on 1 December 1986 will be a U.S. resident for all of 1985 and 1986.

[16] If an alien is a U.S. resident for the current year (under either test) but was not a U.S. resident for the preceding year, he is treated as a U.S. resident for that portion of the year beginning with his "residency starting date". Such date is the first day in the year on which the alien is present in the U.S. as a lawful permanent resident if he qualifies as a resident only under the "permanent residence" test. If an alien qualifies under the "substantial presence" test, his "residency starting date" is the first day during the year on which he is present in the U.S. As to the last year of residence, an alien is not treated as a U.S. resident for the part of a year that is after the last day in the year on which he was present in the U.S. or a lawful permanent resident there, provided that he (i) had a closer connection to a foreign country than to the U.S. during that portion of the year and (ii) is not a U.S. resident at any time during the next year.

[17] House Report (note 10) at 906; Conference Committee Report on the Tax Reform Act of 1984, reprinted in *CCH Federal Tax Guide Reports*, No. 42 of 20 July 1984 (hereinafter "Conference Report") at 908. The Conference Report adds that an alien will be treated as a U.S. resident for purposes of the internal laws of the U.S. even if he is treated as a resident of the treaty partner for treaty purposes. This means, for example, that, if an alien is a U.S. resident under the new definition and owns more than 50% of the voting stock in a foreign corporation, that corporation will be a "controlled foreign corporation" (see note 6).

rather than the "place of management" test. A "domestic corporation" is one "created or organized in the U.S." (i.e. within the geographical limits of the 50 States or the District of Columbia) or "under the law of the U.S. or of any State" (i.e. under federal law or the law of any State or the District of Columbia) (IRC, Sec. 7701(a)(4)). A "foreign corporation" is a corporation which is not a "domestic corporation" (IRC, Sec. 7701(a)(5)).

Since the definition of "domestic corporation" is in the alternative (i.e. created or organized "in" or "under"), there could be a conflict if, for example, the organizing activities required for incorporation take place in the U.S. but the corporation is organized under the laws of a foreign country from which it derives its legal existence. In such a case, the operative part of the definition is generally considered to be "under the laws of. . .".[18]

Whether or not an entity (domestic or foreign) is a corporation for U.S. tax purposes is determined under U.S. law. IRC, Sec. 7701(a)(3) states that "corporation" includes associations, joint stock companies and insurance companies, and Reg. 301.7701-1(c) provides, in part, that "corporation" is not limited to the artificial entity usually known as a corporation but also includes an association and a trust classed as an association because of its nature or activities.

"Association" means an organization whose characteristics require it to be classified as a corporation rather than as another type of organization, such as a partnership (Reg. 301.7701-2(a)). An organization is treated as a corporation if its "corporate characteristics" are such that it more nearly resembles a corporation than a partnership or trust. For this purpose, the six "corporate characteristics" to take into account are: associates, an objective to carry on business and divide the profits, continuity of life, centralized management, limited liability and free transferability of interests (Reg. 301.7701-2(a)).

III. THE SOURCE RULES

The source rules in IRC, Secs. 861-863 do not impose a tax or grant exemptions. Instead, their limited and exclusive function is to prescribe the criteria for determining whether certain items of income are treated as derived from sources within or without the U.S. or from sources partly from within and partly from without the U.S.

IRC, Secs. 861 and 862 provide the rules applicable to specific types of income. As to items of income not specified, the IRS has broad authority under IRC, Sec. 863(a) to issue regulations allocating such income to sources within or without the U.S.[19]

A. Income from sources within and without the U.S.

The items of income dealt with in IRC, Secs. 861 and 862 are discussed below.

1. Interest

"U.S.-source interest" means interest (i) from the U.S. (or any agency or instrumentality), a State (or any of its political subdivisions), or the District of Columbia and (ii) on bonds, notes and other interest-bearing obligations of "residents", a term which includes U.S. resident individuals, domestic corporations, domestic partnerships engaged in business in the U.S., and foreign corporations or partnerships engaged in business in the U.S. (IRC, Sec. 861(a)(1); Reg. 1.861-2(a)). Any other interest is from foreign sources (IRC, Sec. 862(a)(1)).

As exceptions to the general rule in IRC, Sec. 861(a)(1), the following interest is not considered as being from U.S. sources:

(1) Interest received by a non-resident alien or foreign corporation which consists of (a) interest on deposits with persons (including U.S. citizens, aliens, and foreign or domestic corporations or partnerships) engaged in the banking business in the U.S.; (b) interest on deposits with savings and loan institutions organised under federal or state law; or (c) amounts held by an insurance company under an agreement to pay interest thereon (e.g. prepaid insurance premiums) (IRC, Sec. 861(c); Reg. 1.861-2(b)).

However, the interest in (a), (b) or (c) is considered foreign-source income *only* if it is *not* effectively connected with the foreign person's business in the U.S.; if it is so connected, it constitutes U.S.-source interest, unless it is excluded under (2), (3) or (4).

(2) Interest received from a resident alien or a domestic corporation if less than 20% of his/its total gross income for the preceding 3-year period (or such part as may be applicable) was derived from U.S. sources. If the 20% test for exclusion (as U.S.-source interest) is not satisfied, all of the interest from such person is U.S.-source income.

(3) Interest received from a foreign corporation engaged in business in the U.S. if less than 50% of its total gross income for the preceding 3-year period (or such part as may be applicable) was effectively connected with such business. If the 50% test for exclusion (as U.S.-source interest) is not satisfied, a proportional part of the interest is U.S.-source income. This paragraph does not apply to interest paid by a banking branch of a foreign corporation; such interest is covered by the rules in (1).

(4) Interest paid on deposits with a foreign banking branch of a domestic corporation or partnership, whether or not the corporation or partnership is engaged in the banking business in the U.S.

2. Dividends

The criteria for determining the source of dividends relate to the distributing corporation's status as a domestic or foreign corporation and to its source of income (IRC, Sec. 861(a)(2)(A) and (B)). Dividends from a

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[18] Owens (note 2) at 43-44.

[19] To date, the IRS has issued regulations (in Reg. 1.863-1(b)) only with respect to income derived from natural resources in the U.S.

domestic corporation are U.S.-source income unless the 20% test for exclusion applicable to interest (see Section III.A.1(2)) is satisfied, in which case none of the dividends is considered to be U.S.-source income. Dividends from a foreign corporation are foreign-source income if the 50% test for exclusion applicable to interest (see Section III.A.1(3)) is satisfied. If the test is not satisfied, a proportional part of the dividends is U.S.-source income.

3. Compensation for personal services

The controlling factor for determining the source of compensation for personal services is the place where they are performed: the compensation is U.S.-source income if the services are performed in the U.S. and foreign-source income if performed outside the U.S. (IRC, Secs. 861(a)(3), 862(a)(3)). "Personal services" refers to the nature of the services performed and does not mean services "personally performed"; thus, personal services may be performed by a corporation or by an individual through an agent.[20]

As an exception, compensation for personal services performed in the U.S. is not U.S.-source income if all of the following conditions are satisfied:

(1) the services are performed by a non-resident alien individual who is temporarily in the U.S. for a period not exceeding a total of 90 days during the taxable year;

(2) the compensation does not exceed $ 3,000 in the aggregate; *and*

(3) the services are performed as an employee of or under a contract with (a) a non-resident alien, foreign corporation, or foreign partnership, not engaged in business in the U.S. or (b) a U.S. citizen or resident or a domestic corporation or partnership, if the services are performed for an office or place of business maintained in a foreign country by such individual, corporation or partnership.

The $ 3,000 in (2) is a condition for exclusion and not an exemption. If the total compensation exceeds this amount, the entire compensation constitutes U.S.-source income. Apportionment may be required if a lump sum is paid for services performed partly within and partly outside the U.S., and, in many cases, apportionment on the basis of time is acceptable (Reg. 1.861-4(b)).

4. Rents and royalties

For tangible property, the criterion for determining the source of income is its geographic location and, for intangible property, the criterion is the geographic area where it may be used. Rents and royalties from tangible property (or any interest therein) located in the U.S. constitute U.S.-source income, as do rents and royalties for the use of or the privilege of using in the U.S. patents, copyrights, secret processes and formulas, good will, trademarks and similar intangible property (IRC, Sec. 861(a)(4)). Other rents and royalties constitute foreign-source income (IRC, Sec. 862(a)(4)).

5. Gain from the disposition of "U.S. real property interests"

Gain from the disposition of a "U.S. real property interest" (see Section V.C.1.) is U.S.-source income, and gain from the disposition of real property located outside the U.S. is foreign-source income (IRC, Secs. 861(a)(5), 862(a)(5)).

6. Gain from the sale of personal property

The "place of sale" is the criterion for determining the source of income from the sale of personal property purchased (but not manufactured or produced – see Section III.B.) by the taxpayer and sold by him. The entire gain from the sale is U.S.-source income if the sale takes place in the U.S. and foreign-source income if the sale takes place outside the U.S. (IRC, Secs. 861(a)(6), 862(a)(6)).

The "place of sale" is where the rights, title and interest of the seller in the property are transferred to the buyer or where, if the seller retains bare legal title, beneficial ownership and risk of loss pass to the buyer (Reg. 1.861-7).[21] However, if tax avoidance is the primary purpose for structuring a sales transaction in a particular way, these rules will be disregarded and the IRS will look at all the facts to determine where the substance of the sale took place (Reg. 1.871-7).

7. Underwriting income

Underwriting income, generally defined in IRC, Sec. 832(b)(3) as premiums earned on insurance contracts less losses and expenses, derived from insuring "U.S. risks" is U.S.-source income and other underwriting income is from foreign sources (IRC, Secs. 861(a)(7), 862(a)(7)). "U.S. risks" generally refers to risks in connection with property or liability arising from activities in the U.S. or with the lives and health of U.S. residents (IRC, Sec. 953(a)).

8. Social security benefits

Social security benefits received after 31 December 1983 constitute U.S.-source income (IRC, Sec. 861(a)(8)).

9. Income from certain aircraft, vessels and spacecraft

Owners of certain aircraft, vessels and spacecraft which are manufactured or constructed in the U.S. are required to treat as U.S.-source income any income from the lease of such property to third persons that are U.S. persons. Any gain from the sale or other disposition of such property is also considered U.S.-source income (IRC, Sec. 861(e)).

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[20] Roberts, S.I. and Warren, W.C., *U.S. Income Taxation of Foreign Corporations and Nonresident Aliens*, Practicing Law Institute, New York, 1966-1971 (hereinafter "Roberts") at VI-27 to VI-28.

[21] The "place of sale" rules apply to tangible and intangible property alike. If intangible property is represented by marketable documents, the title passage rule is applied to the documents; in other situations, it is not entirely settled (by statute, regulation or case law) where the sale is deemed to occur, but it may be where the contract of sale was accepted. See Owens (note 2) at 70-71 and Roberts (note 20) at VI-47 to VI-52.

B. Income partly from U.S. and partly from foreign sources

Among the types of income identified in IRC, Sec. 863(b) as being partly from within and partly from without the U.S. are:

(1) Income from the sale of personal property produced (in whole or in part) in the U.S. by the taxpayer and sold by him outside the U.S., and vice versa. "Produced" includes created, fabricated, manufactured, extracted, processed, cured or aged (IRC, Sec. 864(a)). Reg. 1.863-3(b) identifies the three methods which may be used in determining the U.S.-source portion and the foreign-source portion of income so derived.

(2) Transportation income derived from providing transportation services between points in the U.S. and other points. Reg. 1.863-4 indicates how such income is to be divided between its U.S.-source component and its foreign-source component.

The Tax Reform Act of 1984 amended the rules relating to transportation income by adding IRC, Sec. 863(c) which provides that all transportation income attributable to transportation which begins and ends in the U.S. must be treated as U.S.-source income. This rule is designed to prevent certain carriers from treating (as they could under the existing rules) almost all of certain transportation income as foreign-source income, even though the transportation was between two points in the U.S., by using a route of transport which lay primarily outside the U.S.'s 3-mile territorial limit.[22]

IV. INCOME EFFECTIVELY CONNECTED WITH A TRADE OR BUSINESS IN THE U.S.

The Foreign Investors Tax Act of 1966 introduced the concept of "income effectively connected with the conduct of a trade or business in the U.S." and provides that only such income is subject to the regular U.S. income tax rates (see Section V.B.). The "effectively connected" test is based on the taxpayer's status (i.e. is he engaged in business in the U.S.?) and on the character of the various types of income derived by him.

A. Trade or business in the U.S.

A foreign person's being engaged in a trade or business in the U.S. ("U.S. business") may have important tax consequences not only for him but for others as well. For the foreign person, it establishes the possibility that certain income derived by him is "effectively connected" income; it also means that certain items of income which would otherwise escape tax are taxable (see Section IV.B. and C.). For the shareholders and creditors of a foreign corporation, the fact that it is engaged in a U.S. business means that the dividends or interest they receive might be regarded as U.S.-source income (see Section III.A.1. and 2.).

The determination of whether a foreign person is engaged in a U.S. business is made for each taxable year, and, if he is not engaged in a U.S. business during a taxable year, none of the income he derives that year is treated as "effectively connected" income (IRC, Sec. 864(c)(1)(B)).[23]

1. Statutory rules

Neither the IRC nor the Regulations contain a comprehensive definition of "trade or business within the U.S.", but IRC, Sec. 864(b) provides rules regarding three types of activities:

(1) The performance of personal services in the U.S. constitutes a U.S. business unless the services are performed by a non-resident alien temporarily in the U.S. and *all* the conditions necessary for treating his compensation as foreign-source income are satisfied (see Section III.A.3.).

(2) Trading in stocks, securities (e.g. notes, bonds, debentures) or commodities through a resident broker, commission agent or other independent agent does not constitute a U.S. business, provided that the foreign person does not maintain an office or other fixed place of business in the U.S. through which the transactions are effected. This rule applies to any foreign person, including brokers and dealers in stocks or securities (Reg. 1.864-2(c)(1)).

(3) Trading in stocks, securities or commodities for the foreign investor's own account, whether directly by the foreign person or through his employees or agents, does not constitute a U.S. business, unless the foreign person is (i) a dealer in stocks, securities or commodities or (ii) a foreign corporation whose principal business is trading in stocks or securities for its own account *and* whose principal office is in the U.S.[24]

For situations not covered by (1), (2) or (3), whether or not a foreign person is engaged in a U.S. business is to be determined on the basis of all the facts and circumstances (Reg. 1.864-2(e)). A foreign person is engaged in a U.S. business if he is a partner or beneficiary of a partnership, trust or estate that is engaged in a U.S. business (IRC, Sec. 875).

2. Revenue Rulings and court decisions

Since the term "trade or business" is used in many provisions of the IRC,[25] there have been many Revenue Rulings and court decisions interpreting that term. It is not possible to examine or summarize these Rulings or decisions in this article, but a few general principles are mentioned below.

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[22] Joint Committee Summary of Tax Provisions of H.R. 4170, reprinted in *Tax Notes* of 9 July 1984 (hereinafter "Joint Committee Summary") at 155,163.

[23] For example, if a foreign person is engaged in a U.S. business during one taxable year and derives income from such business which is paid (and taxable) in the following year (e.g. income from installment sales) during which he is not engaged in a U.S. business, such income is not regarded as "effectively connected" income. See the examples in Reg. 1.864-3(b).

[24] Whether a foreign corporation's principal office is in the U.S. is determined by comparing the activities (other than trading in stocks and securities) conducted from the corporation's U.S. office with those conducted from its offices outside the U.S. (Reg. 1.864-2(c)(2)(iii)).

[25] E.g. IRC, Sec. 162 (deduction for expenses paid in carrying on any trade or business), Sec. 165 (deduction for losses incurred in a trade or business), Sec. 166 (defining "business bad debt" as one created or acquired in connection with a trade or business).

As a general rule, a taxpayer's activities in the U.S. must be continuous and sustained rather than casual or incidental in order to give rise to a trade or business.[26] In addition, there must be "substance" to the activities or transactions; the mere collection of income from passive investments is insufficient.[27]

Many cases in this area have involved foreign persons owning real property in the U.S., and the Revenue Rulings and cases have generally held that those owners whose activities in the U.S. did not go beyond the receipt of rent and the payment of related expenses were not engaged in a U.S. business.[28] On the other hand, foreign owners were found to be engaged in a U.S. business if their activities were considerable, continuous and regular, e.g. they employed managing agents who collected rents, arranged leases, provided for repairs, paid expenses, etc.[29]

B. "Effectively connected" income

IRC, Sec. 864(c)(2) establishes the "asset-use" test and "business-activities" test as the ones to use, in the alternate, to determine whether items of income are, or are not, effectively connected with a foreign person's U.S. business. These tests apply to three categories of income: (i) capital gains, (ii) "fixed or determinable annual or periodical" income and other income described in IRC, Secs. 871(a)(1) and 881(a) (see Section V.A.1.) and (iii) portfolio interest (see Section V.A.2.).

If a foreign person is engaged in a U.S. business and derives U.S.-source income which does not fall into (i), (ii) or (iii), such income is deemed to be "effectively connected" with his U.S. business, whether or not it is so connected (IRC, Sec. 864(c)(3)). This is the limited extent to which the "force of attraction" principle has been retained. Examples of income to which this omnibus provision might apply are income from sporadic inventory sales or mail-order sales within the U.S. by a foreign sales branch of a foreign person that also has a U.S. sales branch.[30]

1. Asset-use test

Under the asset-use test, the question is whether the income is derived from assets used in, or held for use in, the conduct of a U.S. business (IRC, Sec. 864(c)(2)(A)).[31] This test is ordinarily applied with respect to passive income where the activities of the U.S. business do not directly give rise to the income, and the test is of primary significance where, for example, a foreign person that is engaged in the business of selling or manufacturing in the U.S. derives dividends or interest from U.S. sources (Reg. 1.864-4(c)(2)).

An asset is ordinarily treated as used in, or held for use in, the conduct of a U.S. business if it is (a) held for the principal purpose of promoting the *present* conduct of the U.S. business, e.g. stock acquired and held to assure a constant source of supply for the business, (b) acquired and held in the ordinary course of business, e.g. accounts or notes receivable arising from the business, or (c) otherwise held in a direct relationship to the conduct of the U.S. business, i.e. is the asset *presently* needed in that business? (Reg. 1.864-4(c)(2)).[32]

2. Business-activities test

The purpose of the business-activities test is to determine whether passive income (e.g. dividends, rents, royalties) arises directly from the U.S. business, and, under this test, the question is whether the activities of the U.S. business were a material factor in realizing the income (IRC, Sec. 864(c)(2)(B)). This test is applied primarily to, for example, income and gains derived by dealers in stocks or securities or investment companies and royalties derived by those engaged in the business of licensing patents.[33] In applying the test, the activities relating to the management of investment portfolios are not treated as activities of the U.S. business unless such activities constitute the principal activity of the U.S. business (Reg. 1.864-4(c)(3)).

C. "Effectively connected" foreign-source income

Under IRC, Sec. 864(c)(4), certain foreign-source income of a foreign person engaged in business in the U.S. is treated as "effectively connected" with that business and taxed accordingly. These rules, introduced by the Foreign Investors Tax Act of 1966, are designed to prevent the use of the U.S. as a tax haven[34]

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[26] *Continental Trading Co. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959), cert. denied, 361 U.S. 827. For example, one loan to a domestic corporation was held not to constitute a U.S. business *(Jorge Pasquel*, 23 Tax Court Memoranda 8 (1953)), and the same result was reached with regard to two isolated sales transactions in New York *(Linen Thread Co., Ltd. v. Commissioner*, 14 T.C. 725 (1950)).

[27] *Eugene Higgins v. Commissioner*, 312 U.S. 212 (1941).

[28] See Revenue Ruling 73-522 (1973-2 Cumulative Bulletin 226) and the cases cited therein.

[29] *J.C. Lewenhaupt*, 20 T.C. 151 (1953), affirmed 221 F.2d 227 (9th Cir. 1955); *Inez de Amodio*, 34 T.C. 894 (1960), affirmed 299 F.2d 623 (3rd Cir. 1962).

[30] See the examples in Reg. 1.864-4(b); see also Mehlman, "The Foreign Investors Tax Act of 1966", 20 *Univ. So. Cal. Tax Institute* 625 (1968), reprinted in part in Owens (note 2) at 138, 143.

[31] In applying both the "asset-use" and "business-activities" tests, due regard must be given to whether or not the asset or income was accounted for through the U.S. business, i.e. whether or not it is carried on the books of account separately kept for that business, but this accounting test is not by itself controlling (IRC, Sec. 864(c)(2); Reg. 1.864-4(c)(4)).

[32] An asset is considered to be needed in a business only if it is held to meet the present needs, e.g. operating expenses, of the business and not its future needs, e.g. future diversification or expansion, future plant replacement (Reg. 1.864-4(c)(2)). This Regulation also states that a direct relationship is presumed to exist if (i) the asset was acquired with funds generated by that business, (ii) the income from the asset is retained or reinvested in that business, *and* (iii) personnel who are present in the U.S. and actively involved in the conduct of that business exercise significant management and control over the investment of the asset.

[33] Reg. 1.864-4(c)(5) provides detailed rules for applying the business-activities test to banking, financing and similar businesses conducted in the U.S.

[34] See Roberts (note 20) at VB-5. The legislative history of these provisions gives the example of a foreign corporation (organized under the laws of a country that does not tax the corporation's foreign-source income) that has a sales office in the U.S. through which it sells its products in a third country. Without the rules in IRC, Sec. 864, the corporation could avoid tax on the sales income in all three countries: in its home country because it does not tax foreign-source income; in the U.S. under the title-passage rule, and in the source country because it does not have a permanent establishment there.

and to insure that income which is economically derived from the U.S. is subject to tax there.[35]

The three types of foreign-source income which may be treated as "effectively connected" with a foreign person's U.S. business are:

(1) rents or royalties for the use of intangible property (see Section III.A.4.), including gain from the disposition of such property, derived in the active conduct of a U.S. business;

(2) dividends or interest, or gain from the disposition of shares or securities, which are (i) derived in the active conduct of a banking, financing or similar business in the U.S. or (ii) received by a foreign corporation whose principal business is trading in shares or securities for its own account; and

(3) income from the sale of inventory items (or other property held primarily for sale to customers) where the sale occurs outside the U.S. but is effected through the U.S. office of the foreign person; however, such income is not "effectively connected" if the property is sold for consumption outside the U.S. and the taxpayer's foreign office participated materially in the sale.

These types of foreign-source income are treated as "effectively connected" only if the foreign person has an office or other fixed place of business in the U.S. ("U.S. office") to which such income is "attributable". The concept of "U.S. office" generally corresponds to the concept of "permanent establishment" in tax treaties.[36] If a foreign person has an agent in the U.S., the agent's office does not constitute the foreign person's "U.S. office" unless the agent (i) possesses and regularly exercises the authority to negotiate and conclude contracts for the foreign person or maintains inventory from which he regularly fills orders on behalf of the foreign person *and* (ii) is not a general commission agent or other independent agent (IRC, Sec. 864(c)(5)(A)). "Attributable" means that the foreign person's "U.S. office" is a material factor (i.e. makes a significant contribution) in the production of the income and that the office regularly carries on the activities from which the income is derived (IRC, Sec. 864(c)(5)(B); Reg. 1.864-6(b)).

Notwithstanding the above rules, no foreign-source income is treated as "effectively connected" income if it (i) consists of dividends, interest or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the voting stock or (ii) is "Subpart F income".[37]

V. INCOME TAXATION OF FOREIGN PERSONS

IRC, Secs. 871-884 identify the types of income which are subject to income tax in the hands of non-resident aliens or foreign corporations and prescribe the method for computing the taxable base and the tax due. These rules must be considered in conjunction with other provisions of the IRC because income which is not includible in the gross income of a U.S. citizen or resident or a domestic corporation is not includible in the gross income of a foreign person.[38] Thus, for example, interest on bonds issued by any of the 50 States or the District of Columbia (excluded from gross income under IRC, Sec. 103) is not taxable when received by a foreign person. Conversely, items of (U.S.-source) income (e.g. alimony) which are included in gross income under the IRC constitute gross income in the hands of a foreign person, even though the item is not specifically mentioned in the source rules (IRC, Secs. 861-863).[39]

A. Income not effectively connected with a U.S. business

1. Income subject to tax at 30% and capital gains

IRC, Secs. 871(a)(applicable to non-resident aliens) and 881(a)(applicable to foreign corporations) impose a tax of 30% on the gross amount of the following five types of U.S.-source income derived by a foreign person, but only if the income is not effectively connected with the person's U.S. business:

(1) Interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other "fixed or determinable annual or periodical gains, profits, and income".

"Fixed or determinable annual or periodical gains, profits, and income" is not defined in the IRC, but the term is intended as a catch-all phrase for the types of income the tax with regard to which can be collected by way of withholding. The term generally includes any type of income which is susceptible to withholding.[40]

(2) Gains from certain disposals of timber, coal or domestic iron ore.

(3) Income from original issue discount ("OID") obligations,[41] as follows:

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[35] Ross, "United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments", 22 *Tax L. Rev.* 279, 328 (1966-1967), reprinted in part in Owens (note 2) at 147. This article states (at 158) that the U.S. is not really attempting to tax foreign-source income, although that is the technical format of the statute, but is, instead, providing that certain foreign-source income should, under the traditional rules of U.S. law, be regarded as U.S.-source income and subject to tax.

[36] Roberts (note 20) at VB-11.

[37] This exception was included because "Subpart F income" is generally taxable in the hands of the U.S. shareholders of a "controlled foreign corporation". See note 6.

[38] Regs. 1.871-7(a)(2) and 1.881-2(a) provide that the term "amount received" in IRC, Secs. 871(a) and 881 (imposing a tax on non-resident aliens and foreign corporations) means "gross income", a term defined in IRC, Sec. 61(a). This definition applies to all persons subject to income tax under the IRC. See Roberts (note 20) at VI-7 and Owens (note 2) at 223-224.

[39] Roberts (note 20) at VI-7 to VI-8.

[40] Reg. 1.1441-2 states that the term is merely descriptive of the character of a class of income, and, if an item of income falls into this class, it is immaterial whether it is paid in a series of payments or a lump sum, e.g. a single royalty payment is deemed "annual or periodical" since royalties are generally within this class of income. This Regulation defines "fixed" as meaning that the income is paid in definitely predetermined amounts and "determinable" as meaning that there is a basis of calculation by which the amount to be paid may be ascertained. This definition has been found to be so broad as to be virtually meaningless. See Roberts (note 20) at VII-3.

[41] "OID obligation" means any bond or other evidence of indebtedness having original issue discount, excluding any obligation payable in 183 days or less from the date of original issue and any obligation which is tax exempt under IRC, Sec. 103 or other provision of law (New IRC, Sec. 871(g)).

(i) the amount of gain from the sale or exchange of an OID obligation which does not exceed the OID (generally, the difference between the issue price and the stated redemption price at maturity) accruing while the foreign person held the obligation, to the extent the discount was not taken into account under (ii), and

(ii) the amount of interest paid on an OID obligation which is equal to the OID accrued on the obligation since the last payment of interest.

The Tax Reform Act of 1984 added the provisions in (3) in order to clarify the rules governing income that foreign investors earn from OID obligations and to make the rules conform to those governing U.S. investors.[42]

(4) Gain from the sale or exchange of intangible property (described in Section III.A.4.), or any interest therein, to the extent that the gains are from payments which are contingent on the productivity, use or disposition of the property (or interest) or from payments which are treated as being so contingent. If 50% or more of the gain for any taxable year from the sale or exchange of intangible property (or interest) are from payments which are contingent on the productivity, use or disposition of such property or interest, all of the gain for that taxable year is treated as being so contingent (IRC, Sec. 871(e)).

(5) Gains from certain distributions from qualified pension and profit sharing plans (applicable only to non-resident aliens).

For non-resident aliens, the 30% tax is also imposed on (i) one half of social security benefits received after 1983 (IRC, Sec. 871(a)(3)) and (ii) the individual's net capital gain, but such gain is taxable only if the alien was present in the U.S. for 183 days or more (not necessarily consecutive) during the taxable year (IRC, Sec. 871(a)(2)). (However, such an alien may be regarded as a resident under the new rules discussed in Section II.A.2.) For other non-resident aliens and for all foreign corporations, capital gains which are not effectively connected with a U.S. business are exempt from tax. But see Section V.C.I. for the special rules applicable to gains from the disposition of "U.S. real property interests".

Foreign persons are not allowed any deductions from the income subject to the 30% tax (IRC, Secs. 873(a), 882(c)), but they may take the credits allowed for the taxes withheld on wages and at source, for certain uses of gasoline and special fuels, and for overpayments of tax (Regs. 1.871-7(e), 1.881-2(d)). The credit for overpayments of tax may be taken only if a proper and timely tax return is filed (IRC, Secs. 874(a), 882(c)).

The 30% tax is generally levied by way of withholding (IRC, Secs. 1441, 1442), except that no withholding is required with regard to income derived from the sale of real or personal property in the U.S. (Reg. 1.1441-2(a)(3)). Thus, capital gains subject to tax are exempt from the withholding requirement; however, gains from certain dispositions of "U.S. real property interests" are not (see Section V.C.1.).

2. Portfolio interest

The Tax Reform Act of 1984 added IRC, Secs. 871(h) (applicable to non-resident aliens) and 881(c) (applicable to foreign corporations) that repeal the 30% tax on "portfolio interest" paid to foreign persons by U.S. borrowers. The repeal is effective for interest paid on portfolio obligations issued after 18 July 1984.[43] "Portfolio interest" is defined as interest, including OID, paid on:

(1) an obligation not in registered form (bearer debt) that (i) is sold under procedures reasonably designed to prevent the sale or resale to U.S. persons, (ii) bears interest payable only outside the U.S., and (iii) indicates that U.S. holders are subject to tax penalties; or

(2) an obligation in registered form (registered debt) as to which the U.S. person who would otherwise be required to withhold tax has received a statement that the beneficial owner of the obligation is not a U.S. person.

"Portfolio interest" does not include interest paid to:

(a) a shareholder who owns 10% or more of the total voting stock of the paying corporation (in the case of corporate obligations) or a person who owns 10% or more of the capital or profits interest in a partnership (in the case of obligations issued by the partnership);

(b) a foreign bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of business, but this exception does not apply to interest paid on obligations of the U.S.; or

(c) a controlled foreign corporation[44] by a related person.

B. Taxation of "effectively connected" income

All income and capital gains which are effectively connected with a U.S. business are subject to tax in the same manner as if they were derived by U.S. citizens or residents or by domestic corporations (IRC, Secs. 871(b), 882(a)). The income tax rates for individuals range from 11% to 50%, and those for corporations from 15% to 46% (IRC, Secs. 1, 11). Individuals may deduct 60% of capital gains from gross income, and corporations either include the entire gain in taxable income at the regular rate or apply a special 28% rate, whichever produces the lower tax (IRC, Secs. 1201, 1202).

These tax rates apply to a foreign person's "taxable income" which is determined by deducting from gross income: (a) items which are otherwise allowed by the IRC and which are connected, or properly allocable, to gross income effectively connected with a U.S. business, and (b) charitable contributions (IRC, Secs. 873, 882(c)). Non-resident aliens may also claim one personal exemption and deduct non-business casualty and theft losses if the loss is of property located in the U.S.

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[42] Joint Committee Summary (note 22) at 164.

[43] Joint Committee Summary (note 22) at 164.

[44] A "controlled foreign corporation" is a foreign corporation in which more than 50% of the voting stock is owned by "U.S. shareholders", i.e. shareholders that own at least 10% of the voting stock (IRC, Secs. 951, 957). See note 6.

(IRC, Sec. 873(b)). However, aliens who are residents of Canada or Mexico may claim all the personal exemptions which are allowed under the IRC.

Foreign persons may take the credits allowed with regard to income subject to the 30% tax as well as certain other credits, such as the credit for foreign taxes (subject to the limitations in IRC, Sec. 906) and the credit for investment in certain depreciable property (Regs. 1.871-8(d), 1.882-1(d)). These credits and the deductions mentioned above may be taken only if a proper and timely tax return is filed (IRC, Secs. 874(a), 882(c)), but this limitation does not apply to the credits for taxes withheld on wages and at source and for certain uses of gasoline and special fuels.

Except as otherwise provided in Section V.C. and except for income which consists of compensation for personal services, no withholding is required with regard to income effectively connected with a U.S. business (IRC, Secs. 1441(c), 1442(a)).

C. Other income taxed as "effectively connected"

1. "U.S. real property interests"

The Foreign Investment in Real Property Tax Act of 1980 added IRC, Sec. 897 which provides that gains (or losses) from the disposition of a "U.S. real property interest" by a foreign person are mandatorily treated as income effectively connected with a U.S. business. Thus, such gains are always taxable in the U.S., either as ordinary income or as capital gains. A minimum tax of 20% of the net gain applies to gains derived by non-resident aliens (IRC, Sec. 897(a)(2)), but in exceptional cases the rate may be higher. If this tax treatment conflicts with a treaty obligation of the U.S., the treaty provision prevails until 1 January 1985; afterwards, the rules in IRC, Sec. 897 will prevail, but transitional rules apply in certain treaty situations.[45]

"U.S. real property interest" is broadly defined in IRC, Sec. 897(c) as either:

(1) a direct interest in real property (including an interest in a mine, well, or other natural deposit) located in the U.S. or the Virgin Islands; or

(2) with certain exceptions, any interest (other than one solely as a creditor) in any *domestic* corporation which is a "U.S. real property holding corporation" ("RPHC") during a specified period of time; however, if a corporation's stock is regularly traded on an established securities market, the stock is considered a "U.S. real property interest" only in the hand of a shareholder who owns more than 5% of the stock (IRC, Sec. 897(c)(3)).

A RPHC is any corporation, domestic or foreign, if the fair market value of its "U.S. real property interests" is at least 50% of the sum of the fair market value of (i) its "U.S. real property interests", (ii) its interests in foreign real property, and (iii) any other asset which is used or held for use in a trade or business (IRC, Sec. 897(c)(2)).

An interest in a foreign RPHC is not a "U.S. real property interest"; therefore, disposition of such an interest does not come under the rules applicable to interests in domestic RPHCs. Instead, the foreign corporation is subject to tax when it disposes of its "U.S. real property interests", whether by sale or exchange, dividend distribution, or distribution pursuant to a redemption or liquidation (IRC, Sec. 897(d)).

The Tax Reform Act of 1984 added a withholding system applicable to dispositions of "U.S. real property interests" pursuant to which the buyer is required to withhold, unless one of the 5 exemptions applies, the lesser of (i) 10% of the amount realized by the foreign person disposing of a "U.S. real property interest" or (ii) such person's maximum tax liability (New IRC, Sec. 1445, effective for dispositions on or after 1 January 1985). However, no withholding is required if: (a) the seller gives the buyer an affidavit stating that the seller is not a foreign person; (b) in the case of the transfer of stock, the corporation gives the buyer an affidavit that the corporation is/was not a RPHC during the requisite time; (c) the buyer purchases the property to use as his residence and the purchase price is $ 300,000 or less; (d) the transferred property is stock which is regularly traded on an established securities market; or (e) the buyer receives a "qualifying statement" (defined in IRC, Sec. 1445(b)(4)) from the IRS.

2. Election regarding real property income

A non-resident alien or foreign corporation that owns investment real property in the U.S. and derives income from it which is not "effectively connected" income may *elect* to treat income or gains from the property as "effectively connected" income (IRC, Secs. 871(d), 882(d)). A foreign person that makes this election is not regarded as being engaged in business in the U.S. on account of the election (Reg. 1.871-10).

As a practical matter, this election is available only with regard to certain kinds of income (e.g. rents) from real property, but not to gains from the disposition of the property since such gains are necessarily treated as "effectively connected" income under IRC, Sec. 897 (see preceding Section).

3. Students, teachers and trainees

A non-resident alien who is not engaged in business in the U.S. and who is temporarily in the U.S. as part of certain exchange or training programs (under the sections of the Immigration and Nationality Act relating to visiting students, teachers and trainees) is mandatorily treated as being engaged in a U.S. business, and the taxable portion of any U.S.-source scholarship or fellowship grant received by such individual is regarded as "effectively connected" income (IRC, Sec. 871(c); Reg. 1.871-9). Such income is subject to withholding at the rate of 14% (IRC, Sec. 1441(b)).

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[45] Foreign Investment in Real Property Tax Act of 1980, Sec. 1125.

The following two articles were written by Servaas van Thiel, research associate at the International Bureau of Fiscal Documentation.

U.N. Draft Code of Conduct on Transnational Corporations[1]

INTRODUCTION

The increased internationalization of investment through the use of large internationally organized corporate structures since the early 1960s has focused international attention on the complex tripartite relation between home country, investor, and host country. A proliferation of international declarations and bilateral or multilateral investment treaties was the result. Guidelines for the behaviour of parties involved in the process of international investment were formulated. Examples outside the U.N. structure[2] are the 1967 OECD Draft Convention on the Protection of Foreign Property, the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, the 1972 ICC Guidelines for International Investment and the 1976 OECD Declaration and Decisions on Guidelines for Multinational Enterprises, National Treatment, International Investment Incentives and Disincentives and Consultation Procedures. Examples from within the U.N. structure[3] are the 1974 U.N. General Assembly Resolutions on the Establishment of a New International Economic Order and on the Charter of Economic Rights and Duties of States, the 1980 UNCTAD Draft Code of Conduct on the Transfer of Technology, the 1980 U.N. set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices and finally, the 1984 version of the U.N. Draft Code of Conduct for Multinational Enterprises (see note 1). All these declarations cannot be legally enforced before national or international courts, because according to the statute of the International Court of Justice they are not to be regarded as sources of international law.[4] Apart from these international declarations many states have recently concluded bilateral investment treaties (over 200 have been concluded since 1960) or have included investment related clauses in multilateral agreements such as the Lomé Convention, the Cartagena Agreement, and the UDEAC agreement.[5]

U.N. DRAFT CODE OF CONDUCT

U.N. involvement with Transnational Corporations (hereinafter TNC) dates back to the early 1970s when the ECOSOC provided for the creation of a Group of Eminent Persons[6] to study the role of TNC in international relations. In its report the Group emphasized the necessity to collect information on TNC and to come to a regulation of their conduct. Accordingly a U.N. Commission and a U.N. Centre on TNC were created[7]; the former to formulate a code of conduct and the latter to collect information on TNC activities and to provide technical cooperation to developing countries in their dealings with TNC.[8] During its second session in 1975 the Commission established an Intergovernmental Working Group in order to formulate a draft code of conduct. This Working Group completed its task in 1982[9] and submitted a draft code to the Commission. Items in the draft code on which no consensus could be reached were printed between brackets, the usual U.N. technique of "concluded provisions".

In October 1982 ECOSOC decided that work on the Code should be completed by the Commission itself in special sessions.[10] These sessions have resulted in the

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[1] "United Nations Commission on Transnational Corporations: Report of the Secretariat on the outstanding issues in the draft code of conduct on Transnational Corporations", Economic and Social Council Document E/C.10/1984/S/5 of 29 May 1984 as reprinted in XXIII International Legal Materials (3) May 1984, at 602.

[2] Resolution of the OECD Council adopted at its 150th meeting, on 12 October 1967. The ILO Declaration was made in 1977 by the Governing Body of the Internationational Labour Office. *International Legal Materials* 2, 1978 at 423-430. The text of the Guidelines was unanimously adopted by the Council of the International Chamber of Commerce at its 120th session, on 29 November 1972. Declaration of the OECD Council of Ministers of 21 June 1976.

[3] Respectively Resolution 3201 (S-VI) as adopted during the General Assembly Special Session of 9 April – 2 May 1974, and Resolution 3281 (XXIX) as adopted on 12 December 1974 during the 29th Session. Over the years 1952-1973 several other General Assembly resolutions dealt with permanent sovereignty and international investment including resolutions 626 (VII), 1314 (XIII), 1515 (XV), 1803 (XVII), 2158 (XXI), 2692 (XXV), 3016 (XXVII), 3171 (XXVIII).
U.N. Document TD/code/TOT/25 of 2 June 1980.
United Nations Conference on Restrictive Business Practices, U.N. Document TD/RBP/conf/10 of 2 May 1980.

[4] Art. 38 of the I.C.J. Statute mentions the following sources of international law: Treaties, customary law, general principles of law, judicial decisions and teachings of the most qualified scholars.

[5] Second Lomé Convention, Official Journal of the European Communities, L 347, 1980 at 51. Articles 60 to 64 contain rules relating to international investment. See: Regulation Governing Common Treatment of Foreign Capital, Trademarks, Patents, Licenses and Royalties approved by Decisions Nos. 24, 37, 37-A and 70 of the Commission of the Cartagena Agreement (Particularly Art. 27). See Arts. 45 and 46 of the 1964 Treaty establishing the "Union Douanière et Economique de l'Afrique Centrale".

[6] ECOSOC resolution 1721 (LIII) of 28 July 1972.

[7] ECOSOC resolutions 1908 (LVI) and 1913 (LVII) of 2 August and 5 December 1974 respectively.

[8] The U.N. Centre on Transnational Corporations did not start to work until after appointment of the first Executive Director at the end of 1975.

[9] Final report E/C.10/1982/6 containing the draft code of conduct.

[10] On the basis of ECOSOC resolution 1982/LXVIII of 27 October 1982 a special session was organized in 2 parts: from 7-18 March 1983 and from 9-20 May 1983. The U.N. General Assembly decided at its 38th session (decision 1983/183 of 29 July 1983) that another special session should be held in the beginning of 1984 in order to facilitate the negotiation of outstanding issues. This session took place from 9-13 January 1984 and was reconvened from 11 to 29 June 1984.

present report (see note 1) which deals with the outstanding issues in the draft code and the various proposals to solve them. The Code is divided in a preamble and 5 parts dealing respectively with the definitions and scope of application, the activities of TNC (further subdivided in: A. General and political; B. Economic, financial and social; C. Disclosure of Information), the treatment of TNC (further subdivided in: A. General treatment of TNC by the countries in which they operate; B. Nationalization and compensation; C. Jurisdiction), intergovernmental cooperation and implementation of the code of conduct (further subdivided in: A. Action at a national level; B. International institutional machinery; C. Review procedure). The preamble has not been drafted yet and among the major outstanding issues in the other sections of the code are the meaning of the concept of sovereignty, the rules concerning the treatment of TNC by host countries, the rules of transfer pricing and the subject of unrestricted transfer of payments. These subjects are tax related because they either refer to government activities imposing directly or indirectly a financial burden on TNC or deal with general obligations which also apply to fiscal situations.

National sovereignty (paras. 6, 7, 37, 41, 44 and 45 of Draft Code)

In various contexts the Code would require TNC to respect national sovereignty of the countries in which they operate and to abide by the prevailing laws, regulations, policies and administrative practices. Though none of the paras mentioned refer expressly to taxation, paras 6 and 7 (observance of domestic law) and 44 and 45 (financial and other disclosure requirements) would apply in fiscal situations.

Para. 6[11] deals with national and permanent sovereignty over national resources and economic activities, a concept which has frequently been used in the recent past by developing countries to unilaterally change the conditions of concession agreements with TNC. Sometimes these changes were limited to increases in royalties and taxes to be paid by the TNC but sometimes the entire enterprise was nationalized. It is for this reason that there is a fundamental difference of opinion on the scope of the concept. Most delegates from developed countries felt the need to qualify national sovereignty with a reference to international law including the principles of "pacta sunt servanda" and no nationalization without adequate compensation. They also wanted a reference to bilateral treaties that would limit the concept of sovereignty. Delegates of developing countries however wanted to reinforce the principle of sovereignty over natural resources which they considered to be a well-established principle of international law.[12] A compromise suggests a general reference to "the fulfilment in good faith of international obligations". Para. 7[13] submits TNC to national laws, regulations and administrative practices of the host countries. The problem here concerns the scope of "administrative practices". As these practices can be changed overnight, certain delegates wanted to change the concept into "established" or "explicitly declared" administrative practices so as to ensure the stability of the investment climate. It was agreed that a solution should be found.

Paras. 44 and 45[14] concern disclosure of information by TNC. Agreement exists on annual publication of financial and other information and on the obligation of TNC to supply upon request or on a regular basis "all information required for legislative and administrative purposes". This item should include information held in other countries and needed by the authorities of the

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[11] Transnational corporations should/shall respect the national sovereignty of the countries in which they operate and the right of each State to exercise its (full permanent sovereignty) (in accordance with international law) (in accordance with agreements reached by the countries concerned on a bilateral and multilateral basis) over its natural resources (wealth and economic activities) within its territory.

[12] Sovereignty over natural resources has been mentioned in several U.N. resolutions, the most prominent of which is the 1974 Charter of Economic Rights and Duties of States, General Assembly Resolution 3281 XXIX as reproduced in *69 American Journal of International Law 1975* at 484 and *14 International Legal Materials 1975* at 251.

[13] (Transnational corporations) (Entities of transnational corporations) (shall/should observe) (are subject to) the laws, regulations (jurisdiction) and (administrative practices) (explicitly declared administrative practices) of the countries in which they operate. (Entities of transnational corporations are subject to the jurisdiction of the countries in which they operate to the extent required by the national law of these countries.)

[14] Transnational corporations should disclose to the public in the countries in which they operate, by appropriate means of communication, clear, full and comprehensible information on the structure, policies, activities and operations of the transnational corporation as a whole. The information should include financial as well as non-financial items and should be made available on a regular annual basis, normally within six months and in any case not later than 12 months from the end of the financial year of the corporation. In addition, during the financial year, transnational corporations should wherever appropriate make available a semi-annual summary of financial information.

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The non-financial information should include

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(e) Policies applied in respect of transfer pricing.
The information provided for the transnational corporation as a whole should as far as practicable be broken down:
By geographical area or country . . .
By major line of business . . .
The method of breakdown as well as details of information provided should/shall be determined by the nature, scale and interrelationships of the transnational corporation's operations, with due regard to their significance for the areas or countries concerned.
The extent, detail and frequency of the information provided should take into account the nature and size of the transnational corporation as a whole, the requirements of confidentiality and effects on the transnational corporation's competitive position as well as the cost involved in producing the information.
The information herein required should, as necessary, be in addition to information required by national laws, regulations and administrative practices of the countries in which transnational corporations operate.
Transnational corporations should/shall supply to the competent authorities in each of the countries in which they operate, upon request or on a regular basis as specified by those authorities, and in accordance with national legislation, all information required for legislative and administrative purposes relevant to the activities and policies of their entities in the country concerned.
Transnational corporations should/shall, to the extent permitted by the provisions of the relevant national laws, regulations, administrative practices and policies of the countries concerned, supply to competent authorities in the countries in which they operate information held in other countries needed to enable them to obtain a true and fair view of the operations of the transnational corporation concerned as a whole in so far as the information requested relates to the activities of the entities in the countries seeking such information.
The provisions of paragraph 51 concerning confidentiality shall apply to information supplied under the provisions of this paragraph.

host country to obtain a true and fair view of the operations of the TNC as a whole, insofar as the information relates to the activities of the entities in the host country.

A general paragraph 51[15] seeks to safeguard the confidentiality of the information supplied but a difference of opinion still exists on the exact wording. Some delegates prefer the term "confidential business secrets" and others prefer "legitimate business interests".

Treatment of transnationals (paras. 48, 49, 54, 58 of Draft Code)

All delegates agree that states have the right to regulate the entry and establishment of TNC and to prohibit or limit the extent of their presence in specific sectors. Agreement also exists on the provision[16] that TNC should receive fair and equitable treatment although there is again a difference of opinion on whether or not a reference to international law should be included.

On the other hand, one of the most controversial issues in the draft is para. 49 on "national treatment"[17] which implies non-discriminatory treatment of TNC vis-à-vis domestic enterprises. Most developing countries accept the principle of non-discrimination but stress the unequal position of domestic enterprises towards TNC, and consequently want to limit the application of the non-discriminatory treatment to those situations in which the circumstances under which TNC operate are similar to those of domestic enterprises. Others even want to limit the application of the principle with a general reference to "vital national interests".

The chairman of the special session group presented a compromise text which includes the reference to similar circumstances and provides for exceptions to the principle for a) national requirements for maintaining public order and protecting national security and other vital interests; b) consistency with socio-economic systems as reflected in national constitutions and other laws; c) measures specified in legislation and policies relating to declared development objectives of the developing countries.

Many delegates however expressed their reserves towards this compromise. Paras 54 and 56[18] contain the traditionally controversial issue of nationalization, compensation and dispute settlement.[19] The well-known Latin American point of view of non-applicability of international law and exclusive national jurisdiction (Calvo clause) is reflected in the first alternative formulation of para. 54.

The position of the Developed Countries, also reflecting classical international law, is formulated in the second alternative whereas the third and fourth alternatives contain intermediate positions.

Because of the fundamental and long standing differences of views on this subject the Intergovernmental Working Group considered the possibility of a procedural treatment whereby the various positions would merely be acknowledged without even formulating a compromise. There is little chance that, on the basis of

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[15] Information furnished by transnational corporations to the authorities in each of the countries in which they operate containing (legitimate business secrets) (confidential business information) should be accorded reasonable safeguards normally applicable in the area in which the information is provided, particularly to protect its confidentiality.

[16] States have the right to regulate the entry and establishment of transnational corporations including determining the role that such corporations may play in economic and social development and prohibiting or limiting the extent of their presence in specific sectors.
Transnational corporations should receive (fair and) equitable (and non-discriminatory) treatment (under) (in accordance with) the laws, regulations and administrative practices of the countries in which they operate (as well as intergovernmental obligations to which the Governments of these countries have freely subscribed) (consistent with their international obligations) (consistent with international law).

[17] Consistent with (national constitutional systems and) national needs to (protect essential/national economic interests,) maintain public order and to protect national security, (and with due regard to provisions of agreements among countries, particularly developing countries,) entities of transnational corporations should be given by the countries in which they operate (the treatment) (treatment no less favourable than that) (appropriate treatment) accorded to domestic enterprises under their laws, regulations and administrative practices (when the circumstances in which they operate are similar/identical) (in like situations). (Transnational corporations should not claim preferential treatment or the incentives and concessions granted to domestic enterprises of the countries in which they operate.) (Such treatment should not necessarily include extension to entities of transnational corporations of incentives and concessions granted to domestic enterprises in order to promote self-reliant development or protect essential economic interests.) (Some delegations preferred not to have a second sentence.)

[18] (In the exercise of its right to nationalize or expropriate totally or partially the assets of transnational corporations operating in its territory, the State adopting those measures should pay adequate compensation taking into account its own laws and regulations and all the circumstances which the State may deem relevant. When the question gives rise to controversy or should there be a dispute as to whether a nationalization or expropriation has taken place, it shall be settled under the domestic law of the nationalizing or expropriating State and by its tribunals.)
(In the exercise of their sovereignty, States have the right to nationalize or expropriate foreign-owned property in their territory. Any such taking of property whether direct or indirect, consistent with international law, must be non-discriminatory, for a public purpose, in accordance with due process of law, and not be in violation of specific undertakings to the contrary by contract or other agreement; and be accompanied by the payment of prompt, adequate and effective compensation. Such compensation should correspond to the full value of the property interests taken, on the basis of their fair market value, including going concern value, or where appropriate other internationally accepted methods of valuation, determined apart from any effects on value caused by the expropriatory measure or measures, or the expectation of them. Such compensation payments should not be subject to any restrictive measures applicable to transfers of payments, income or capital.)
(In the exercise of its sovereignty, a State has the right to nationalize or expropriate totally or partially the assets of transnational corporations in its territory, and appropriate compensation should be paid by the State adopting such measures, in accordance with its own laws and regulations and all the circumstances which the State deems relevant. Relevant international obligations freely undertaken by the States concerned apply.)
(A State has the right to nationalize or expropriate the assets of transnational corporations in its territory against compensation, in accordance with its own laws and regulations and its international obligations.)
(Disputes between a State and an entity of a transnational corporation operating in its territory are subject to the jurisdiction of the courts and other competent authorities of that State unless amicably settled between the parties.)
(Disputes between a State and an entity of a transnational corporation which are not amicably settled between the parties or resolved in accordance with previously agreed dispute settlement procedures, should be submitted to competent courts or other authorities, or to other agreed means of settlement, such as arbitration.)
(Disputes between States and entities of transnational corporations, which are not amicably settled between the parties, shall/should be submitted to competent national courts or authorities in conformity with the principle of paragraph 7. Where the parties so agree, such disputes may be referred to other mutually acceptable dispute settlement procedures.)

[19] Before World War II a rule of international customary law (the opinio

the 4 alternatives offered, agreement on a compromise will be reached in short time.

Para. 56 concerning dispute settlement between States and entities of TNC gives rise to the basic question whether or not a reference should be made in the Code to international arbitration. Many developing countries were not in favour of this reference whereas most developed countries considered it essential. It is interesting to note however that many developing countries do accept a reference to international arbitration in their national investment laws or in the bilateral investment treaties concluded by them.[20]

Taxation and transfer pricing (paras. 33 and 34 of Draft Code)

The Intergovernmental Working Group reached agreement on the basic principles regarding appropriate pricing policies in intra-corporate transactions. Para. 33 of the code calls for the use of market prices or prices based on the arm's length principle so that neither the tax base on which the companies are assessed is modified nor exchange control measures are evaded.[21]

Disagreement remained however on other pricing policies such as those evading customs valuation regulations or, more in general, those that "adversely affect economic and social conditions" of host countries. This latter reference is very general and unclear and this was the main reason for many delegates to object to it.

The clause on transfer pricing is rather vague. Firstly, it presupposes a general understanding and agreement on the term "arm's length" whereas in fact there are various methods to determine an arm's length price.[22] Obviously the most ideal method would be to directly refer to prices in comparable transactions between enterprises which are independent of each other.

However this "comparable uncontrolled price method" will not be applicable in certain cases (e.g. when the products delivered are very specialized or when there is an absolute monopoly position) so that alternative methods must be used.

One of these alternatives would be the "cost plus and resale method". In order to establish a price this method starts from the cost of all inputs and adds whatever appropriate cost and profit mark-up. Very close to this method is the "resale method" which starts from the final selling price and substracts all costs and an appropriate profit mark-up.

Nevertheless, the methods described above might fail to provide a clear solution in many situations so that recourse has to be taken to other methods.

None of them however will produce a clearcut answer because in every price determination there will be moments of estimation and value judgement. In any case the Draft Code of Conduct is clear in that it chooses the arm's length principle of price determination thus leaving aside the so-called "global" or "direct" methods which allocate profits between affiliates by reference to predetermined formulae which disregard market conditions and particular circumstances of individual enterprises.

Secondly, there is no reference in the article to disclosure of information so that recourse must be taken to the general articles 44, 45 and 51, as mentioned above.

Thirdly, there is no provision for adjustment procedures in the case TNC do not use arm's length pricing policies. Should there be a unilateral action of the country in which the entity, not applying the arm's length principle, is established? Or should there be a concerted action of all countries in which the TNC has entities? What should a TNC do if several national tax authorities unilaterally decide to adjust prices in such a way that double taxation arises? The code does not mention that problem at all.

Para. 34[23] deals with taxation and calls upon TNC not to illegally modify the tax base on which their entities are assessed. There was no disagreement on this subject. The combination of paras. 33 and 34 however is somewhat strange. It deals with the rather complex matter of tax "evasion", i.e. tax minimization through a breach of the law, as opposed to tax "avoidance" i.e. tax minimization whilst remaining within the law.

A first remark concerns the fact that para. 34 in general deals with tax evasion whereas para. 33 deals with a particular form of tax evasion. Why should only transfer pricing be mentioned separately in the Draft Code of Conduct whereas there are other schemes of evasion such as falsification of stocks and accounts, misrepresentation of the legal position, fictitious transactions and false description or classifications?[24] A second remark concerns the fact that no reference is made to tax avoidance.[25] Of course the demarcation line between avoidance and evasion is not very clear. But there certainly are avoidance schemes which are abusive and

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iuris and practice of a majority of states) prohibited nationalization without payment of compensation. The rule is reflected in the famous Hull doctrine named after the U.S. foreign secretary, which conditions nationalization on reasons of public interest and on prompt payment of adequate and effective compensation.

With the emergence of new states and socio-economic systems this practice changed and the subject has been controversial ever since.

[20] See for instance the list of bilateral treaties with reference to the 1965 International Centre for the Settlement of Investment Disputes between States and Nationals of other States as published every year in the I.C.S.I.D. annual reports.

[21] In respect of their intra-corporate transactions, transnational corporations should/shall not use pricing policies that are not based on relevant market prices, or, in the absence of such prices, the arm's length principle, which have the effect of modifying the tax base on which their entities are assessed or of evading exchange control measures (or customs valuation regulations) (or which (contrary to national laws and regulations) adversely affect economic and social conditions) of the countries in which they operate.

[22] "Transfer pricing and Multinational Enterprises". Report of the OECD Committee on Fiscal Affairs, Paris 1979 at 13.

[23] Transnational corporations should/shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle, or other means, to modify the tax base on which their entities are assessed.

[24] Prof. G. Tixier, "Definition, Scope and Importance of International Tax Evasion", "International Tax Evasion and Avoidance" Colloquy of the Council of Europe, Strasbourg, 5-7 March 1980, Publications of the International Bureau of Fiscal Documentation No. 31, Amsterdam, 1981.

[25] Prof. J.C.L. Huiskamp: "Definition, scope and importance of international tax avoidance, supra note 19.

contrary to the intentions of the legislature. Examples are the widespread use of tax havens, the more or less artificial legal constructions to channel income through certain countries and the misuse of loopholes in national legislation and double taxation treaties.

Finally there is an imbalance in the code's dealing with taxation in that it only mentions tax evasion whereas no word is said about the prevention of double taxation. These problems form the two sides of one and the same coin.

Transfer of payments (para. 53 of Draft Code)[26]

A much disputed subject concerns the unrestricted transfer of all investment related payments such as profits, dividends, royalties, technical assistance and management fees, savings of expatriate personnel and liquidation proceeds.

Developed countries favor unrestricted transfer without prejudice to the relevant provisions of the Code on balance of payments problems (para. 29). In this respect they refer to established international commercial practices and principles of the IMF and GATT. Developing countries however object to the inclusion of such a paragraph because of their fragile balance of payments positions. They feel that all transfers should be subject to national exchange control regulations and individual investment contracts which usually specify the amount and timing of the transfers in accordance with national foreign exchange positions. Both positions are rather extreme but understandable. A sudden prohibition of transfer of payments might frustrate the entire planning of a TNC or, worse, cause such a financial crisis that bankruptcy is faced. In those cases it is a question whether the foreign exchange problems of the countries involved could not be solved through other measures such as import restrictions, even if they cause political and social problems. Should the choice of these solutions be left entirely to the national government or not?

It must also be said that sudden foreign exchange restrictions have been misused to force foreign investors to accept certain national policies and to reinvest parts of their profits.

On the other hand sudden transfers of investment related income by a group of foreign investors might cause serious balance of payments problems and frustrate national development plans.[27]

CONCLUSION

As we have seen above, the Draft Code contains some of the most disputed topics in international law; topics that have rigidly divided groups of countries over the past decades. Therefore it is not very likely that a final version of the Code will be accepted in the near future as *the* international legal text to govern the relation between home country, investor and host country. Nevertheless it must be clear to all parties involved that international investment flows are seriously hindered by the many uncertainties that exist up to this moment. This might be a reason for the States involved in the negotiations to dismantle with grace their ideological approach in order to solve the problems in a more pragmatic way.

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26. [53. Transnational corporations should be able to transfer freely and without restriction all payments relating to their investments such as income from invested capital and the repatriation of this capital when this investment is terminated, and licensing and technical assistance fees and other royalties, without prejudice to the relevant provisions of the "Balance of payments and financing" section of this Code and, in particular, its paragraph 29.]
[To be deleted]

27. The massive outflow of foreign investment from Liberia following the 1980 coup d'etat in spite of the continuation of liberal investment policies is a good example.

CAMEROON:

New Investment Code

1. INTRODUCTION

The attitude of the Government of Cameroon towards private investment is rather positive. In order to encourage and stimulate economic activity a new investment code[1] defining the conditions under which natural persons and corporate bodies may be offered guarantees and benefits was adopted in June 1984. It defines various Schedules under which new or expanding investors may be placed and defines the rights and obligations attached thereto. Benefits under the Investment Code are granted through an approval document. The conditions are to be determined by Decree.[2]

Placement under the first 3 special Schedules (A-C) of the 1984 Investment Code is effected by statutory instrument. Placement under Schedule D is effected by a contract subject to prior approval by law. For placement under any of the Schedules a recommendation from the National Investments Committee is a prerequisite; also approved persons will be subject to inspection by the Ministry of Industry and the Customs authorities. Other conditions are to be fixed by Regulation.[3]

The approval document must contain the name, purpose and location of the company; the duration and ef-

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1. Law to institute the Investment Code of Cameroon, passed by the National Assembly at its plenary session held on 25 June 1984, through the adoption of Bill No. 279/PJL/AN. It repeals former laws including the 1960 Investment Law (as amended) and the 1974 Ordinance providing incentives for tourist industries.

2. This Decree, to which section 2 of the Investment Code refers, has not yet been issued (November 1984).

3. These Regulations, to which section 14 of the Investment Code refers, have not yet been issued (November 1984).

fects of the investment program; the benefits granted and the terms and conditions to be fulfilled by the investor. Non-compliance with these terms is an offense and may give rise to substantial penalties.[4]

2. INVESTORS ELIGIBLE FOR BENEFITS

All natural persons and corporate bodies operating individually or in partnership and engaging in or proposing to engage in economic activity may be offered the general guarantees and benefits contained in the 1984 Investment Code.

Economic activity is defined as the processing of materials leading to a change in the quality of the product during the manufacturing or assembling process for the purpose of producing a different article. It also includes the following activities: agricultural-, animal-, forest- and timber industries; tourist industry and hotel trade; building industry and public works; extractive industries and the maintenance of industrial equipment.

The following conditions must be satisfied:

(i) the economic activity must satisfy the needs of the customer in respect of quantity, quality and price;
(ii) the economic activity must contribute to the balanced development and increased competitiveness of all sectors of the national economy;
(iii) the location of undertakings must be consistent with the requirements of regional development and planning taking into account the growth of towns and villages and the economic, social and cultural development plan.

Eligible for the special benefits for promotional enterprises (schedule A) are all undertakings that effect total investments of not less than 500 million F.CFA at prices prevailing in June 1984, and fulfill any one of the following conditions:

(i) they are located in border regions or in areas where access and supply conditions are particularly difficult; or
(ii) their economic activities yield a high value added; or
(iii) they give preference to adapted technologies and use large numbers of skilled manpower while guaranteeing continuous vocational training.

Eligible for the specific benefits for priority undertakings (schedule B) are all undertakings that effect total investments of not less than 2,500 million F.CFA (at prices prevailing in June 1984) in one of the sectors recognised by the government as priority sectors and fulfill any one of the following conditions:

(i) they are located in non-port border areas; or
(ii) they contribute in a considerable and long lasting way to an improvement in the balance of payments in their sector of activity; or
(iii) they have a very high value added and encourage subcontracting with other companies; or
(iv) they give preference to technologies that use a large number of skilled local manpower while guaranteeing continuing vocational training.

Eligible for the specific benefits for small and medium sized undertakings (schedule C) are undertakings which fulfill the following conditions:

(i) at least 65% of the share capital is held by nationals;
(ii) job creating expenses are relatively low;
(iii) continuing vocational training is guaranteed;
(iv) total investments are less than 500 million F.CFA at prices prevailing in June 1984.

Eligible for the specific benefits for enterprises that have signed an establishment contract (schedule D) are undertakings that operate in areas that are recognized as strategic in the implementation of the government's economic, social and cultural development plan and which effect investments up to an amount that corresponds to that of major undertakings in their branch of activity and is not less than 5,000,000,000 F.CFA (at prices prevailing in June 1984) during the first five years of operation.

Eligible for exemption from export duties are all natural persons or corporate bodies whose industrial products are intended for export irrespective of the Schedule in which they are classified.

3. INVESTMENT INCENTIVES

The general benefits and guarantees under the 1984 Investment Code include the following:

(i) the State guarantees the protection of local industries in order to ensure the profitability of investment in economic activity;[5]
(ii) any natural person or corporate body wishing to pursue an economic activity is entitled to acquire rights of all kinds in respect of ownership, concessions and administrative authorization;
(iii) any foreign natural person or corporate body investing in Cameroon has the right to transfer to the country of residence and in the original currency, capital, income, dividends and liquidation proceeds, subject to exchange controls;
(iv) foreign persons operating in Cameroon are, on the basis of reciprocity, entitled to non-discriminatory national treatment in matters of tax and employer obligations.

Promotional undertakings (schedule A), in addition to the general benefits, are granted a reduced rate of 5% for import duties and taxes and an exemption from duties and taxes levied on local purchases in respect of raw materials, equipment, machines, tools, spare parts and products necessary for the manufacturing, processing and packaging or wrapping of the manufactured products for a period not exceeding 10 years.

In addition to the general benefits priority undertakings (schedule B) are entitled:

(i) to the same exemption as granted to promotional undertakings; and
(ii) to an exemption, for a period not exceeding 5 years

[continued at p. 44]

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[4] Penalties may range from a fine to the complete withdrawal of approval. The fine may be as high as 5% of the investor's turnover before taxes.

[5] Section 7 of the Investments Code contains this guarantee and refers specifically to Law 80/25 to orientate commercial activity.

ALGERIA:
Joint Venture Enterprises

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I. INTRODUCTION

The "mixed company" or "mixed economy company" (hereinafter "joint venture"[1]) is a legal entity permitting one or more State-owned enterprises to cooperate with one or more foreign firms with a view toward carrying out a predetermined objective within the framework of the general plan of development.

If this juridical mould seems, in future, privileged by the State as an instrument of international cooperation – parallel to "turnkey" and "production-in-hand" contracts – it is not simply because it is considered an important vehicle for the transfer of technology, but also because it permits the public authorities to reaffirm their sovereignty and to be in a position to exercise their supervisory prerogatives in the economic sector, without, for all that, neglecting the interests of the foreign partner.

As for the foreign investor, he approves of this partnership with public capital especially in a country having opted for a socialist form of development, because it results, at the same time, both in the reduction of his political risks and in the amount of his own investment. This association allows him, as well, to benefit from fiscal and financial advantages and, in particular, to occupy a choice rung on the local market for the commercialization of goods and services.[2]

The promulgation of Law No. 82-13 (hereinafter "Law of 1982") concerning the formation and functioning of the mixed economy company[3] – which is the object of this study, to the exclusion of joint ventures created with the direct participation of the State[4] and those that specialize in the research and exploitation of liquid hydrocarbons[5] – can be explained, essentially, as having two motives.

The first motive results from the legislator having become aware of the mistrust of foreign companies to establish autonomous subsidiaries in Algeria under the Investment Code of 15 September 1966[6] and the tendency of certain foreign companies to prefer an investment carried out through a joint venture.[7]

The second motive flows from the willingness, finally frankly stated, to encourage this type of association and to give uniformity, to a certain measure, to the regulations concerning these legal entities.

The joint venture company, for which regulations have been, thus, promulgated, is marked by the seal of ambiguity. Due to the majority participation of the State enterprise and the necessity to take into consideration the minority interests of the foreign partner, it is sometimes considered a company falling under private law and at other times a company under public law. It is not, however, in relation to this cleavage that this little study was undertaken. We find it, rather, more opportune to analyse, firstly, the formation and, secondly, the legal framework of the joint venture company.

II. THE FORMATION OF A JOINT VENTURE COMPANY

The creation of a joint venture requires the resolution of two preliminary questions: the first concerns its legal foundation, the second, its frame of action.

A. The protocol agreement, legal foundation of the joint venture

The international cooperation which can be established through the expedient of a joint venture between one or more State enterprises and one or more foreign companies is always subordinated to the conclusion of a *protocol agreement,* the contents of which have been given, recently, a certain uniformity with respect to their principal points.

1. The conclusion of the protocol agreement

In the terms of Article 3 of the Law of 28 August 1982, the creation of a joint venture falls within the framework of a protocol agreement concluded, under the legislation in force, between, in most cases, a State-owned enterprise and a foreign firm.

But, because of the interests put into play, completion of such an international agreement must obey certain formalities justified by the right of inspection reserved to the State. The draft agreement cannot, on the one hand, be the object of negotiation by a public enterprise until after the enterprise has obtained the authorization of the ministry under which it falls. On the other hand, once negotiated and signed by all parties, it only enters into force "after approval by interministerial decree taken jointly by the Minister of Finance, the Minister of

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[1] As Algeria is a socialist country, almost all industry is nationalized. Therefore, joint ventures between private enterprises are practically unheard of. "Joint venture", as used here, refers exclusively to cooperation between a State-owned enterprise and a private, foreign, enterprise (Editor's note).

[2] See for the same idea: Florescu, G., "Les sociétés mixtes dans les pays socialistes, nouvelle forme de coopération économique internationale", D.P.C.I., 1978, t.4, No. 2, at 246 et seq.

[3] J.O.R.A. of 31 August 1982, at 1189.

[4] See Terki, "Les codes des investissements au Maghreb", C.M.E.R.A., Algeria, 1979, at 70-71.

[5] See Terki, "La société mixte de droit algérien en matière de recherche et d'exploitation des hydrocarbures liquides", D.P.C.I. 1983, t.9, No. 1, at 9-42.

[6] See Ordonnance No. 66-284 of 15 September 1966, J.O.R.A. of 17 September 1966, at 901.

[7] See Dada, M.D., "Les filiales des entreprises publiques en Algérie", Mémoire pour le D.E.S. de Droit Public, Université d'Alger, 1977.

Planning and Development and the Minister in charge of the particular state enterprise in question" (Law of 1982, Art. 10).

Thereafter, this interministerial decree requires the approval of the joint venture participants. This signifies that the legislator has introduced a relative relaxation into the procedure for establishing foreign capital since, under the regulations of the Code of 1966, the National Investment Commission was required, obligatorily, to give an opinion justifying such formation.[8]

Modification of the protocol agreement thus approved follows the same formality unless there is a substantial change.

2. Contents of the protocol agreement

This international contract, which was, to the exclusion of all law, the only foundation for this type of partnership before 1982, has, first, as its objective to arrange the formation, functioning and eventual dissolution of the joint venture through the repurchase by the State enterprise of the interest held by the foreign associate.

As, from the point of view of the host country, the primary reason for this cooperation is, above all, to benefit from the transfer of technology, the agreement must, further, clearly state "the methods which the foreign partner will bring to the joint venture for them to create together the means and the techniques (patents and technological processes, methods and programs, documentation . . .) which are necessary to accomplish the objective" (Law of 1982, Art. 4(2)). By the same token, it is necessary to state precisely the stages of training of autochthonous employees.

To avoid certain abuses which were noted previous to promulgation of the Law of 28 August 1982, it was made obligatory that the parties to the protocol agreement provide for the conditions of payment due to the foreign partner as well as to the non-Algerian personnel and put such monies at the disposal of the united enterprise.

The legislator has, finally, taken care – always with the notable objective of rectifying some anomalies in the past – to ordain that "the protocol agreement will not, overall, have the effect of imposing obligations liable to impede the economic and technological development of the socialist or mixed economy company. . . (as it) would not have the effect of granting a monopoly on technical assistance to the foreign co-contractor" (Law of 1982, Art. 5). More particularly, this contract must not, in any fashion, impose restrictions either on the volume of activity of the public enterprise – in requiring it, for example, to get its supplies of raw material and equipment from the foreign partner or in utilizing more advantageous technological procedures, or in its "power to fix the prices of products made with the imported technology" (Law of 1982, Art. 4(4)).

Besides the limits on the parties' power to negotiate concerning the contents of the protocol agreement, the legislator did not leave them the option to choose the legal form of the joint company being created.

B. The joint stock company, the legal framework of the joint venture

To fulfill the role assigned it, this type of company needs an autonomy that only the regulations of a purely commercial enterprise can afford it. This is why the partners are obliged – in spirit as well as in practice – to organize their cooperation in the form of a joint stock company (Law of 1982, Art. 20), that is, a commercial company in form.[9]

However, taking into account that the association, in almost all cases, consists of only two shareholders – rather than the nine which are normally required by Article 592 of the Commercial Code[10] – and that one of them must be formerly a member of the public authority, an alteration in the mechanics of the joint stock company (technically too complicated from the outset for this type of enterprise) will naturally flow therefrom.[11] Because of the limitations of this study, however, we must be content merely with a succinct analysis of the particularities marking the formation and organization of this legal entity.

1. Formation of the joint venture

To allow the State enterprise to supervise the management of a joint venture company, it is provided that the capital participation of the State enterprise cannot, under any circumstances, be less than 51% (Law of 1982, Art. 22). Experience has shown, however, that the foreign partner will, for several reasons, agree that the State's rate of participation be even higher than the legal floor.[12]

Under the rules of the Commercial Code, the incorporation meeting determines the value of the capital contributions, established by judicial decision of a commissioner for the designated contributions, at the request of the promoters.

By contrast, as regards the formation of a joint venture, the administration intervenes directly in this operation. Contributions in kind must, in effect, be "the object of an estimate by the competent services of the Ministry of Finance" (Law of 1982, Art. 24), and cleared by the relevant sector's administration; this Minister is to nominate, additionally, two of his assistants on whom he confers the task of Commission of Contributions (Law of 1982, Art. 24).

The joint stock must be fully paid in as of the formation of the joint venture. But, in relation to the nature of the activity, the interministerial agreement decree is able to stagger this operation over time, on condition it does not go beyond a limit of two years (Law of 1982, Art. 23(1)).

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[8] See Terki, "Les codes des investissement au Maghreb", at 68.

[9] Commerce Code, Art. 544(2).

[10] Before the promulgation of the Law of 1982, the public enterprise and its foreign partner subscribed respectively 4 and 3 shares in the name of their agents to adhere to the legal requirement of 9 shareholders. Article 26 of this law eliminates this fiction since it authorizes the number of shareholders by derogation.

[11] See Terki, "L'entreprise d'économie mixte, l'autorité et la responsabilité en Algérie", paper presented at an A.I.D.E. conference held at Rennes on 28 and 29 September 1983.

[12] See Dada, M.D., op. cit., Annex III.

Finally, it is only after obtaining administrative approval for the investment project that the co-contractors are entitled to engage a notary (today merely a civil servant)[13] for the obligatory filing of its duly certified articles.[14] The creation of the legal entity does not take place until the moment of registration of the joint venture in the Registry of Commerce.[15] Under the above conditions, the general incorporation meeting is purely formal in character.

2. Organization of the joint venture

As the joint venture is formed with only two shareholders and, in addition, one of them is a State enterprise, the organization of the joint stock company undergoes an alteration such that the general meeting is no longer required (which we shall not dwell upon here) and there emerges a single managerial voice.

The members of the board of directors of the joint venture are not designated by the general shareholders' meeting. The two partners are authorized to nominate the board in a pro rata ratio to their stock participation (Law of 1982, Art. 27(1)). In other words, since the board of directors must be composed of at least 5 members, the State enterprise and its foreign partner appoint, respectively, 3 and 2 directors.

Either one of the partners may, at any time, replace these directors on the sole condition that such a substitution does not affect "the equilibrium and division of responsibilities between the representatives of the parties" (Law of 1982, Art. 31(2)).

Experience in the management of joint stock companies already reveals that this collegiate organ delegates certain prerogatives to its president. This tendency is a fortiori pushed to the extreme within the framework of the joint venture. "The practice of delegating authority. . . results, in effect, in a total relinquishment by the board of directors."[16]

The president of the board of directors, who holds, in principle, all managerial powers in the company, is appointed by the State enterprise, the majority partner. In fact, it is actually the minister responsible for this legal entity who intervenes, if not to directly suggest a choice, at least to approve it.

The president "assumes, under his responsibility, the general management of the company. He represents (it) in its relations with third parties. . . (he) is vested with the most extensive authority to act in all circumstances in the name of the company".[17] The presidency of the board of directors appears even more like an omnipotent organ since the shareholders' general meetings are purely fictional and the board of directors delegates to the president the quasi-totality of its powers.

Severe limitations exist, in reality, to temper the total authority that the president appears to exercise. The first limitation on this authority is due to the fact that the parent company, that is, the State enterprise, has the right to supervise the management of the joint venture. The second results from the fact that the minority partner is represented by an adjunct managing director who holds important powers.

In an effort to protect the interests of the foreign minority partners, the appointment or removal of the adjunct managing director may be done solely in relation to his competence.

Theoretically, this director "assists the managing director within statutory limitations and in conformance with the protocol agreement" (Law of 1982, Art. 29(2)). In fact, the adjunct managing director is not limited to this role of assisting the president. Quite often, experience reveals the installation "of a genuine co-management (in which) the authority of the adjunct managing director takes on considerable breadth".[18] This is explained, essentially, by the extensive delegation of authority that the president tends to confer on the adjunct managing director, especially in the technical sector. Even though a minority shareholder, the foreign partner enjoys a privileged situation in addition to the advantages it already has from the specific system conferred by the joint venture.

III. THE LEGAL SCHEME OF THE JOINT VENTURE

To have a comprehensive view of the unique legal scheme that the legislator has set up for the mixed economy company, approved by interministerial decree, it is necessary to distinguish between the operational phase and the cessation of these operations.

A. The legal scheme during the course of operations

Only the tax, financial and jurisdictional regulations merit further discussion here.

1. The tax scheme

Among the fiscal advantages offered the joint venture, and, especially, indirectly offered to the foreign partner to encourage it to invest within this legal framework, are, first, an exemption from transfer taxes for acquisition of all real property necessary to carry out the activities of the company. The legal entity benefits, additionally, from exoneration from land tax for a period of five years as of the date of purchase of real property.

During the first three fiscal years, the joint venture is completely exonerated from taxes on industrial and commercial profits. In addition, there is an abatement of tax payable of 50% and 25%, respectively, for the 4th and 5th fiscal years. At all times, profits are only subject to tax reduced by 20%.

Finally, "interest produced by drawing and blocked accounts opened by the joint venture is exempted from the tax on revenue from debts, deposits and surety bonds" (Law of 1982, Art. 12(4)).

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[13] See Zerrouk, K., "La fonction notariale", mimeographed thesis, for a D.E.S. in Private Law, Université d'Alger, 1977.

[14] Commerce Code, Art. 545.

[15] Commerce Code, Art. 549.

[16] Dada, M.D., op. cit., p. 89.

[17] Commerce Code, Art. 637.

[18] Dada, M.D., op. cit., p. 94.

2. The financial scheme

It is understood that the joint venture has the ability, unlike a private company, to finance its investments through contracting loans, in particular on the international financial market, where it has extensive access to bank credit which is entirely State controlled. It should be noted that the conditions of said loans vary in relation "to the actual participation of the foreign partner in the financing of the planned objectives" (Law of 1982, Art. 14).

If it proves necessary to augment the authorized capital of the joint venture and the foreign partner will not agree to subscribe new shares, the State enterprise can then proceed to do so. This necessitates, in consequence, a modification in the composition of the board of directors.

The partial assimilation of the joint venture into a State enterprise not only places it outside normal bankruptcy procedures or receivership[19] but also permits it to benefit from its position as a dealer in foreign commerce and, equally, a capability to conclude international contracts, due to State monopoly in this sector.[20]

The only problem that remains unresolved is the question of whether the legal entity has the right to a general import license,[21] that is, to a foreign exchange allocation, exactly like a national company. Logically the general import license must be proportional to the amount of capital contributed by the State enterprise to the joint venture.

As for the foreign partner in particular, the legislation permits it to wholly transfer the "additional remuneration" remitted to it, whatever the results of the project, in consideration of "its actual material contribution to the transfer of technology" (Law of 1982, Art. 37(2)).

However, paradoxically, the law does not specify any regulations for the transfer of distributed profits by the foreign shareholder. It is to be hoped that administrative rulings will remedy this gap. In the meantime, it would be prudent for the foreign company to settle this question in the protocol agreement.

3. The jurisdictional scheme

All disputes between the joint venture and a State enterprise, not party to the protocol agreement, are subject to obligatory arbitration as foreseen under Ordinance No. 75-44 of 17 June 1975 relating to conflicts arising from relations between State enterprises.[22] However, it should be noted that, for several reasons we need not elaborate on in this study, this procedure has never, to our knowledge, been utilized.

In contrast to Ordinance 75-44, all litigation arising between the founding members of the joint venture falls, in principle, under the jurisdiction of general, ordinary law.

In spite of this legal prescription against arbitration, which seems to be a strong public policy, one, nevertheless, wonders if certain foreign companies do not succeed, taking into account certain examples of their powers of negotiation, in imposing an arbitration clause on their partner. Such an arbitral jurisdiction would be a fortiori competent to settle disputes arising from the cessation of activities of the joint venture.

B. The legal scheme applicable to the cessation of operations

Below we discuss the cessation of operations of the joint venture whereby the foreign interest is repurchased, whereby the joint venture goes through dissolution or, theoretically, whereby it is partially nationalized.

1. Repurchase of the foreign interest

Before the expiration of the protocol agreement the foreign party may, for one reason or another, manifest an intention to cede its interest. Beyond the fact that this operation must not be to the detriment of its cocontractor, the carrying out of this operation requires 12 months' notice. If these two conditions are met, the State enterprise can exercise its right of pre-emption and repurchase the shares of its partner "at written down value". In the opposite case, which is exceptional, the State enterprise can become the transferee.

Where the State enterprise deems that its partner is not suitably executing its material obligations in the transfer of technology, it can, with 1 year's notice, terminate the cooperation and proceed to the repurchase of shares. To avoid all possible abuse, the parties to the protocol agreement must arrange therein the utilization of such an option.

2. Dissolution of the joint venture

If, at the termination of the contractual duration of the legal entity, the parties have not agreed to an extension, the State enterprise may recommend a repurchase of shares. Should it not do so, "the amicable liquidation of the joint venture proceeds, in conformance with legislation in force" (Law of 1982, Art. 45). However, as the ordinary shareholders' meeting is, in principle, entitled to designate one or more liquidators by simple majority vote, difficulties may arise through possible majority abuse. It would be prudent to remedy this possible abuse in the protocol agreement.

3. Nationalization of the foreign interest

"In a case where the public interest requires the recovery by the State of stock in the possession of the foreign partner, such a measure carries with it, ipso jure. . . payment, within a maximum of one year, of an indemnity equal to the written down value of the stock" (Law of 1982, Art. 48). Taking into account developments which have actually taken shape, the legislator seems to have recalled this principle with the thought especially in mind of guaranteeing the interests of the foreign shareholders.

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[19] Commerce Code, Art. 217(4°).

[20] See Law No. 78-02 of 11 February 1976, J.O.R.A. of 14 February 1976 at 114.

[21] Decree No. 74-14 of 30 January 1974, J.O.R.A. of 15 February 1974 at 179.

[22] Issad, M., "L'arbitrage en Algérie", *Revue de l'Arbitrage, 1977,* No. 3 at 228 et seq.

U.S.A.:

Exchange of Information and the Caribbean Basin

Discussion draft and technical explanation of the Caribbean Basin Draft Exchange-of-Information Agreement released by the Treasury Department on 24 July 1984.

This material was submitted by our correspondent Mr. W. Scott Thomas of Brobeck, Phleger & Harrison, San Francisco.

The U.S. Treasury Department is currently attempting to reach agreements with Caribbean nations for the exchange of information which would satisfy the requirements of the 1983 Act establishing the Caribbean Basin Initiative providing trade and tourism benefits for the countries in that region. See also "Tax Havens in the Caribbean" in 38 *Bulletin for international fiscal documentation* 7 (1984) at 316.

The text and the technical explanation of the draft agreement are reproduced below, starting with the introduction to the technical explanation. For the reader's convenience the Treasury's comments follow each section of the draft agreement.

INTRODUCTION

The Discussion Draft of an Agreement for the Exchange of Information With Respect to Taxes (the Agreement) sets forth the elements of an exchange of information agreement which satisfies the standards of section 222 of the Caribbean Basin Economic Recovery Act (the Act). This technical explanation is a guide to the Agreement.

The Agreement is derived from, and expands upon, the relevant portions of Article 26 of the U.S. Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, dated June 16, 1981 (the U.S. Model). Although the U.S. Model is generally limited in scope to income taxes, its scope is expanded to cover all national level taxes for certain purposes such as exchange of information. The Agreement also may cover all national level taxes, including taxes specifically excepted from coverage in the U.S. Model, if a Contracting State so specifies under Article 2, paragraph 1, of the Agreement, as discussed below.

A final agreement need not contain all of the provisions of the Agreement to be acceptable to the United States. For instance, if the domestic laws of each country authorize the tax authorities to take the actions specified in Article 4, paragraph 4, subparagraph a) (relating to compulsory measures for obtaining information), that subparagraph may be deleted with the understanding that such assistance is available on a reciprocal basis. If a certain provision such as the provision for routine exchanges of information contained in Article 4, paragraph 2, would not be reciprocal in operation (i.e., because a Contracting State does not collect information on payments of interest, dividends, royalties or other items of income paid to nonresidents), that provision may be omitted.

DISCUSSION DRAFT

AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF —— FOR THE EXCHANGE OF INFORMATION WITH RESPECT TO TAXES

The Government of the United States of America and the Government of ——, desiring to conclude an Agreement for the exchange of information with respect to taxes (hereinafter referred to as the "Agreement"), have agreed as follows:

Article 1
Object and scope of the agreement

1. The Contracting States shall assist each other to assure the accurate assessment and collection of taxes, to prevent fiscal fraud and evasion, and to develop improved information sources for tax matters. The Contracting States shall provide assistance through exchange of information authorized pursuant to Article 4 and such related measures as may be agreed upon by the competent authorities pursuant to Article 5.

2. Information shall be exchanged to fulfill the purpose of this convention without regard to whether the person to whom the information relates is, or whether the information is held by, a resident or national of a Contracting State.

Technical explanation

This Article sets forth the general purpose of the Agreement, which is primarily to provide methods for the exchange of information that will assist the Contracting States to enforce their tax laws. Specific procedures are to be developed by the competent authorities pursuant to Article 5.

Information concerning any person that may be subject to tax in one or both of the Contracting States is to be exchanged without regard to the residence or nationality of that person or of the person who is in possession of the information.

Article 2
Taxes covered

1. This Agreement shall apply to the following taxes imposed by or on behalf of a Contracting State:

a) in the case of the United States of America,
    (i) Federal income taxes,
    (ii) Federal taxes on self-employment income,
    (iii) Federal taxes on transfers to avoid income tax,
    (iv) Federal estate and gift taxes,
    (v) Federal excise taxes; and

b) in the case of ——.

2. This Agreement shall apply also to any identical or substantially similar taxes imposed after the date of signature of the Agement in addition to or in place of the existing taxes. The competent authority of each Contracting State shall notify the other of changes in laws which may affect the obligations of that State pursuant to this Agreement.

3. This Agreement shall not apply to the extent that an action or proceeding concerning taxes covered by this Agreement is barred by the applicant State's statute of limitations.

4. This Agreement shall not apply to taxes imposed by states, municipalities or other political subdivisions, or possessions of a Contracting State.

Technical explanation

This Article identifies the taxes with respect to which the parties agree to exchange information as provided in subsequent articles of the Agreement.

Paragraph 1 lists the taxes to which the Agreement shall apply. These may include, in addition to the types listed for the United States, taxes on wealth or capital, inheritances, real property, and general consumption, such as value-added and sales taxes. The Agreement takes account of the fact that not all countries are able or willing to provide assistance for certain categories of taxes by listing the specific taxes which each country agrees to cover as of the date of signature.

Paragraph 2 provides that the Agreement shall also apply to any taxes imposed after the date of signature which are substantially similar to the then-existing taxes covered by the Agreement. The competent authorities agree to notify each other of any significant changes in the tax laws and in the procedures for the administration or enforcement of such laws which may affect their obligations pursuant to the Agreement.

Paragraph 3 provides that the Agreement shall not apply to the extent that information pertains to a tax with respect to which an action or proceeding is barred by the applicant State's statute of limitations. The term "applicant State" is defined below. Thus, the applicant State will only request information which it could use in an action or proceeding with respect to a tax covered by the Agreement. This paragraph is not intended to limit the ability of the competent authorities to agree to exchange certain information on a routine basis under Article 4, paragraph 2.

Paragraph 4 provides that the Agreement shall not apply to sub-national level taxes imposed by a Contracting State. This paragraph corresponds to paragraph 6 of Article 26 of the U.S. Model.

Article 3
Definitions

1. In this Agreement, unless otherwise defined:

a) The term "competent authority" means:
  (i) in the case of the United States of America, the Secretary of the Treasury or his delegate, and
  (ii) in the case of ——.

b) The term "national" means:
  (i) in the case of the United States, any United States citizen and any legal person, partnership, corporation, trust, estate, association, or other entity deriving its status as such from the laws in force in the United States; and
  (ii) in the case of ——.

c) The term "person" includes an individual and a partnership, corporation, trust, estate, association or other legal entity.

d) The term "tax" means any tax to which the Agreement applies.

e) The term "information" means any fact or statement, in any form whatever, that may be relevant or material to tax administration and enforcement, including (but not limited to):
  (i) testimony of an individual, and
  (ii) documents, records or tangible personal property of a person or Contracting State.

f) The terms "applicant State" and "requested State" mean, respectively, the Contracting State applying for or receiving information and the Contracting State providing or requested to provide such information.

g) For purposes of determining the geographical area within which jurisdiction to compel production of information may be exercised, the term "United States" means the United States of America, including Puerto Rico, the Virgin Islands, Guam, and any other United States possession or territory.

h) For purposes of determining the geographical area within which jurisdiction to compel production of information may be exercised, the term —— means ——.

2. Any term not defined in this Agreement, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 5, shall have the meaning which it has under the laws of the Contracting State relating to the taxes which are the subject of this Agreement.

Technical explanation

Paragraph 1 defines the principal terms used throughout the Agreement. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Agreement.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. The term is left open to be defined with respect to the other Contracting State.

In the case of the United States, the term "national" is defined as a citizen of the United States as well as any legal person, partnership, corporation, trust, estate, association, or other entity deriving its status as such from the laws in force in the United States. The term is left open to be defined with respect to the other Contracting State.

The term "person" is defined to include an individual, a partnership, a corporation, a trust, an estate, an association or any other entity treated as a legal person under the laws of a Contracting State.

The term "tax" means any tax to which the Agreement applies pursuant to Article 2, paragraph 1.

The terms "information" means any fact or statement, in any form whatever, that may be relevant or material to tax administration and enforcement, including testimony of an individual and documents, records, or tangible personal property of a person or Contracting State. This definition clarifies that the information to be exchanged under the Agreement is limited solely by reference to whether it is relevant or material to a legitimate tax interest of a Contracting State and not by the form in which it exists.

The term "applicant State" means the Contracting State that applies for and/or receives the information. The term "requested state" means the Contracting State that receives the request and/or supplies the information.

For purposes of determining the area over which the United States has jurisdiction to compel production of information, the term "United States" is defined to mean the United States of America, including Puerto Rico, the Virgin Islands, Guam, and any other United States possession or territory. The definition clarifies that the United States may obtain information where that information or the custodian thereof is located within any of these geographical areas. However, as provided in Article 2, paragraph 4, the Agreement does not cover taxes imposed by any of those jurisdictions except the United States itself.

Paragraph 2 provides that, in the case of a term not defined in the Agreement, the domestic law of the Contracting State applying the agreement shall control unless the context in which the term is used requires a definition independent of domestic law or the competent authorities reach agreement on a meaning pursuant to Article 5 (Mutual Agreement Procedure). The term "context" refers to the purpose and background of the provision in which the term appears. This paragraph is the same as Article 3, paragraph 2, of the U.S. Model.

Article 4
Exchange of information

1. The competent authorities of the Contracting States shall exchange information to administer and enforce the domestic laws of the Contracting States concerning taxes covered by this Agreement, including information to effect the determination, assessment, and collection of tax, the recovery and enforcement of tax claims, or the investigation or prosecution of tax crimes or crimes involving the contravention of tax administration.

2. The competent authorities of the Contracting States shall automatically transmit information to each other for the purposes referred to in paragraph 1. The competent authorities shall determine the items of information to be exchanged pursuant to this paragraph and the procedures to be used to exchange such items of information.

3. The competent authority of a Contracting State shall spontaneously transmit to the competent authority of the other State information which has come to the attention of the first-mentioned State and which is likely to be relevant to, and bear significant-

ly on, accomplishment of the purpose referred to in paragraph 1. The competent authorities shall determine the information to be exchanged pursuant to this paragraph and take such measures and implement such procedures as are necessary to ensure that the information is forwarded to the competent authority of the other State.

4. The competent authority of the requested State shall provide information upon request by the competent authority of the applicant State for the purposes referred to in paragraph 1. If the information available in the tax files of the requested State is not sufficient to enable compliance with the request, that State shall take all relevant measures, including compulsory measures, to provide the applicant State with the information requested.

a) The requested State shall have the authority to:

(i) examine any books, papers, records, or other tangible property which may be relevant or material to such inquiry;
(ii) question any person having knowledge or in possession, custody or control of information which may be relevant or material to such inquiry;
(iii) compel any person having knowledge or in possession, custody or control of information which may be relevant or material to such inquiry to appear at a stated time and place and testify under oath and produce books, papers, records, or other tangible property;
(iv) take such testimony of any individual under oath.

b) Laws or practices of the requested State pertaining to disclosure of information

(i) by banks, nominees or persons acting in an agency or fiduciary capacity, or
(ii) respecting ownership of debt instruments or interests in a person (other than an individual)

shall not prevent or otherwise affect the authority of the requested State described in subparagraph a). The competent authorities of the Contracting States shall have authority to obtain and provide information notwithstanding such disclosure laws and practices.

c) Privileges under the laws or practices of the applicant State shall not apply in the execution of a request but shall be preserved for resolution by the applicant State.

5. If information is requested by a Contracting State pursuant to paragraph 4, the requested State shall obtain the information requested in the same manner, and provide it in the same form, as if the tax of the applicant State were the tax of the requested State and were being imposed by the requested State. However, if specifically requested by the competent authority of the applicant State, the requested State shall:

a) specify the time and place for the taking of testimony or the production of books, papers, records, and other tangible property;
b) place the individual giving testimony or producing books, papers, records and other tangible property under oath;
c) permit the presence of individuals designated by the competent authority of the applicant State as being involved in or affected by execution of the request, including an accused, counsel for the accused, individuals charged with the administration and enforcement of the domestic laws of the applicant State covered by this Agreement, and a commissioner or magistrate present for the purpose of rendering evidentiary rulings or determining issues of privilege under the laws of the applicant State;
d) provide individuals permitted to be present with an opportunity to question, directly or through the executing authority, the individual giving testimony or producing books, papers, records and other tangible property;
e) secure original and unedited books, papers, and records, and other tangible property;
f) secure or produce true and correct copies of original and unedited books, papers and records;
g) determine the authenticity of books, papers, records and other tangible property produced;
h) examine the individual producing books, papers, records and other tangible property regarding the purpose for which and the manner in which the item produced is or was maintained;
i) permit the competent authority of the applicant State to provide written questions to which the individual producing books, papers, records and other tangible property is to respond regarding the item produced;
j) perform any other act not in violation of the laws or at variance with the administrative practice of the requested State;
k) certify either that procedures requested by the competent authority of the applicant State were followed or that the procedures requested could not be followed with an explanation of the deviation and the reason therefor.

6. Except as provided in paragraph 4 b) and paragraph 5, the provisions of the preceding paragraphs shall not 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 State or of the other Contracting State;
b) to supply particular items of information which are not obtainable under the laws or in the normal course of the administration of that State or of the other Contracting State;
c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process;
d) to supply information, the disclosure of which would be contrary to public policy (ordre public);
e) to supply information requested by the applicant State to administer or enforce a provision of the tax law of the applicant State, or any requirement connected therewith, which discriminates against a national of the requested State. A provision of tax law, or connected requirement, will be considered to be discriminatory against a national of the requested State if it is more burdensome with respect to a national of the requested State than with respect to a national of the applicant State in the same circumstances. For purposes of the preceding sentence, a national of the applicant State who is subject to tax on worldwide income is not in the same circumstances as a national of the requested State who is not subject to tax on worldwide income.

7. Except as provided in paragraph 6, the provisions of the preceding paragraph shall be construed so as to impose on a Contracting State the obligation to use all legal means and its best efforts to execute a request. A Contracting State may, in its discretion, take measures to obtain and transmit to the other State information which, pursuant to paragraph 6, it has no obligation to transmit.

8. The competent authority of the requested State shall allow representatives of the applicant State to enter the requested State to interview individuals and examine books and records with the consent of the individuals contacted.

9. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of the State and shall be disclosed only to individuals or authorities (including judicial and administrative bodies) involved in the determination, assessment, collection, and administration of, the recovery and collection of claims derived from, the enforcement or prosecution in respect of, or the determination of appeals in respect of, the taxes which are the subject of this Agreement, or the oversight of the above. Such individuals or authorities shall use the information only for such purposes. These individuals or authorities may disclose the information in public court proceedings or in judicial decisions.

Technical explanation

This Article sets forth the basic obligations of the Contracting States to exchange information, the form and manner in which the information shall be obtained and exchanged, the limitations on the obligation of a Contracting State to exchange information, and the limitations on the use of information received by a Contracting State under the Agreement.

Paragraph 1 authorizes the competent authorities to exchange information to administer and enforce the domestic laws of the Contracting States concerning taxes covered by the Agreement. Because the Agreement is not included in a bilateral income tax treaty, the Agreement does not limit this obligation by reference to substantive tax rules. As described below, however, the Agreement does contain a nondiscrimination limitation.

Paragraph 1 specifies that information may be requested for the purposes of effecting the determination, assessment and collection of tax, the recovery and enforcement of tax claims, or the investigation or prosecution of tax crimes or crimes involving the contravention of tax administration. Thus, information may be requested in connection with, and at any stage of, a civil or criminal tax matter of the applicant State. There is no requirement that there be a tax matter or proceeding in the requested State involving the person about whom information is sought. This paragraph corresponds to and elaborates on the scope of the authority and obligation to exchange information described in the first sentence of Article 26, paragraph 1, of the U.S. Model. It describes information "necessary and appropriate to carry out the tax laws of the United States," as required by section 274(h)(6)(C)(i) of the Internal Revenue Code of 1954 (the Code), as amended by section 222 of the Act.

The authority and obligation to exchange information extends to information with respect to persons who are not residents or nationals of a Contracting State. This requirement is found at section 274(h)(6)(C)(i) of the Code, and corresponds to the second sentece of Article 26, paragraph 1, of the U.S. Model.

Paragraph 2 authorizes the competent authorities to establish routine exchanges of information. Where the Contracting States each collect information relating to payments of income to residents of the other Contracting State, it is intended that the competent authorities shall establish procedures for exchanging such items of information. In general, routine exchanges of information shall be on a reciprocal basis.

Paragraph 3 authorizes each competent authority to exchange information spontaneously with the competent authority of the other State. When information has come to the attention of the tax authorities of the first State, the competent authority of that State must determine that such information is likely to be relevant to, and bear significantly on, a tax matter in the other State before it will initiate a spontaneous exchange. The competent authorities are authorized to establish procedures to effectuate spontaneous exchanges of information. Such exchanges are discretionary and, in general, will be made on a reciprocal basis.

Paragraph 4 authorizes the competent authority of the requested State to provide information upon request by the competent authority of the applicant State for the purposes referred to in paragraph 1. In general, the requested State will first attempt to locate the information in its domestic tax files. If the information available in its tax files is not sufficient to satisfy the request, the requested State shall take all relevant measures, including compulsory measures, to provide the applicant State with the information requested.

Subparagraph a) of paragraph 4 sets forth the powers which should be available to the Contracting States to satisfy their obligations under the Agreement. The form of such powers and the manner in which they are implemented is determined by each Contracting State under its internal law. A Contracting State should have the authority to: examine books, papers, records, or other tangible property; question persons having knowledge or in possession, custody or control of information; compel any person having knowledge or in possession, custody or control of information to appear at a stated time and place and testify under oath and produce books, papers, records, or other tangible property; and take testimony of any individual under oath. The information that is the subject of a request must be relevant or material to the inquiry. This subparagraph is intended to satisfy the congressional intent that Contracting States have adequate process for obtaining information. See H.R. Rept. No. 98-266, 98th Cong., 1st Sess. 30 (1983). The United States has adequate process under section 7601 et seq of the Code. The other Contracting State may enact measures providing such process (see Article 8).

Subparagraph b) of paragraph 4 provides that the authority of a Contracting State to obtain information, as described in subparagraph a), shall not be limited by laws or practices of the requested State (i) pertaining to the disclosure of information by banks, nominees or persons acting in an agency or fiduciary capacity, or (ii) respecting ownership of debt instruments or interests in a person (other than an individual). This is required by section 274(h)(6)(C)(i) of the Code, as amended by the Act. The provision need not be included in a final agreement if the internal law of the Contracting State does not have the effect of allowing bank secrecy or undisclosed ownership of shares of securities.

Subparagraph c) of paragraph 4 provides that privileges (such as the attorney-client privilege) under the law of the applicant State may not be applied to prevent the execution of a request in the requested State, but are preserved for resolution by the applicant State. The purpose of this rule is to avoid causing courts of the requested State to determine privileges asserted under the laws of the applicant State.

Paragraph 5 authorizes a requested State to obtain information to which the request relates in the same manner as if its own taxation were involved, notwithstanding the fact that such State may not need such information. The information may then be provided in the form in which it would be used by the requested State in an internal tax matter. However, if requested by the competent authority of the applicant State, the requested State shall follow the procedures described in subparagraphs a) through k). The procedures specified in subparagraphs a) through j) relate to obtaining information in a form that will permit the information to be admitted into evidence in a U.S. court. See H.R. Rept. No. 98-266, supra, at 30. The procedure specified in subparagraph k), in conjunction with those specified in subparagraphs a) through j), is intended to provide such "equivalent circumstantial guarantees of trustworthiness" that a U.S. court may require no further certification or foundation to find the information thus provided admissible in evidence under the Federal Rules of Evidence, Rule 803(24) or 804(5). The proponent of the information will be required to provide notice to an adverse party pursuant to the above Rules of Evidence and Rule 12(d)(1), Federal Rules of Criminal Procedure. The party contesting the authenticity or trustworthiness of information so certified will have the burden of establishing to the satisfaction of the court before which the proceeding is pending, pursuant to a motion under Rule 12, Federal Rules of Criminal Procedure, that the information is not genuine or reliable in order for such information to be excluded from evidence on that ground. Bilateral negotiations may add other procedures to those listed in order to provide information in a form required in another Contracting State.

Paragraph 6 provides that, except as provided in paragraphs 4 b) and 5, the provisions of the preceding paragraphs of Article 4 do not impose on the Contracting States the obligation to: carry out administrative measures at variance with the laws and administrative practices of either State; supply information which is not obtainable under the laws or in the normal course of the administration of either State; supply information which would disclose a trade, business, industrial, commercial or professional secret or trade process; or supply information the disclosure of which would be contrary to public policy. These provisions, found in subparagraphs a) through d) of paragraph 6, are substantially the same as Article 26, paragraph 2, of the U.S. Model.

Subparagraph e) of paragraph 6 provides that a Contracting State is not obligated to exchange information to be used by the applicant State to administer or enforce a provision of tax law which would discriminate against a national of the requested State that is in the same circumstances as a national of the applicant State. For this purpose, a national who is subject to tax by a Contracting State on worldwide income is not in the same circumstances as a national who is not so subject. This subparagraph corresponds to Article 24 of the U.S. Model in setting forth the concept that a bilateral agreement should not be used to enforce tax laws that discriminate on the basis of nationality.

As noted above, the limitation on the obligation of a Contracting State to exchange information set forth in paragraph 6 would not apply with respect to paragraphs 4 b) and 5 of Article 4. Paragraph 6 differs from the U.S. Model in that the U.S. Model does not require a Contracting State to have any particular authority, under its own laws, relating to the kinds of information which it may obtain or the form in which such information may be obtained. The Agreement, in paragraph 4 b) of Article 4, requires that a Contracting State have the authority to collect the kinds of information set forth in paragraph 4 a) without limitation by local rules requiring secrecy about the ownership of bank accounts or bearer shares. Paragraph 5 of Article 4 specifies procedures for obtaining information in a form in which it can be used in the applicant State, while the U.S. Model provides for no such special procedures.

Paragraph 7 provides that the Contracting States shall use their best efforts to execute a request. Notwithstanding the limitations on the obligation of a Contracting State set forth in paragraph 6, a Contracting State may, in its discretion, take measures to obtain and transmit to the other State information which it is not obligated to transmit.

Paragraph 8 provides that the exchange of information upon request may also take the form of allowing representatives of the applicant State to enter the requested State to interview individuals and to examine records with the consent of the individual contacted. This provision permits officials of the applicant State to participate directly in gathering information in the requested State. While such officials would have no authority to compel disclosure of information, the provision recognizes that their presence may be helpful in obtaining the particular information that would be most useful, and in the most appropriate form, when information is being provided voluntarily. There is no comparable provision in the U.S. Model, which only deals with information obtained by the requested State.

Paragraph 9 provides that any information received by a Contracting State pursuant to the Agreement is to be treated as secret in the same manner as information obtained under the taxation laws of that State. Such information shall be disclosed only to individuals or authorities (including judicial or administrative bodies) involved in the determination, assessment, collection, and administration of, the recovery and collection of claims derived from, the enforcement or prosecution in respect of, or the determination of appeals in respect of, the taxes which are the subject of this Agreement, or the oversight of the above. A.U.S. Grand Jury is considered to be such a judicial body. The information may be used by such persons only for such purposes. The provisions include authorization for the U.S. competent authority to allow the General Accounting Office to examine tax return information received under the Agreement when the GAO is engaged in a study of the administration of U.S. tax laws pursuant to a directive of Congress. Because of these secrecy requirements, information received by an applicant State from a requested State may not be disclosed to authorities of another country without permission from the requested State.

Article 5
Mutual agreement procedure

1. The competent authorities of the Contracting States shall agree to implement a program to carry out the purposes of this Agreement. This program may include, in addition to exchanges specified in Article 4, other measures to improve tax compliance, such as exchanges of technical know-how, development of new audit techniques, identification of new areas of non-compliance, and joint studies of non-compliance areas.

2. 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. In particular, the competent authorities may agree to a common meaning of a term and may determine when costs are extraordinary for purposes of Article 6.

3. The competent authorities of the Contracting States may communicate with each other directly for the purposes of reaching an agreement under this Article.

Technical explanation

This Article authorizes the competent authorities of the Contracting States to establish the programs necessary to implement the exchanges authorized by the Agreement and to resolve by mutual agreement difficulties or doubts arising from the interpretation and application of the Agreement. The competent authorities may agree to the common meaning of a term, determine when costs are extraordinary for purposes of Article 6 (Costs), and consult with each other to agree with respect to automatic and spontaneous exchanges of information, as well as specific requests, pursuant to Article 4 (Exchange of Information). Paragraph 3 permits the competent authorities to communicate with each other directly for purposes of implementing any aspect of the Agreement without going through diplomatic channels.

Article 6
Costs

Unless the competent authorities of the Contracting States otherwise agree, ordinary costs incurred in providing assistance shall be borne by the requested State and extraordinary costs incurred in providing assistance shall be borne by the applicant State.

Technical explanation

In general, ordinary costs incurred in providing assistance shall be borne by the requested State and extraordinary costs shall be borne by the applicant State. The determination of what costs are extraordinary will be the subject of mutual agreement pursuant to Article 5, paragraph 2.

Article 7
Implementation

A Contracting State shall enact such legislation as may be necessary to effectuate this Agreement.

Technical explanation

Where necessary to effectuate the substance of the Agreement, a Contracting State shall enact implementing legislation. Pursuant to Article 8, paragraph 2, the Agreement shall not enter into force until such legislation is enacted as law.

Article 8
Entry into force

FORMULA A
This Agreement shall enter into force upon signature by the duly authorized representatives of the Contracting States.

FORMULA B
This Agreement shall enter into force upon an exchange of notes by the duly authorized representatives of the Contracting States confirming their mutual agreement that both sides have met all constitutional and statutory requirements necessary to effectuate this Agreement.

Technical explanation

In general, the Agreement shall enter into force upon its signature by the duly authorized representatives of the Contracting States. However, if implementing legislation is necessary, the Agreement shall enter into force upon an exchange of notes by the duly authorized representatives of the Contracting States confirming their mutual agreement that both sides have met all constitutional and statutory requirements necesssary to effectuate the Agreement.

Article 9
Termination

This Agreement shall remain in force until terminated by one of the Contracting States. Either Contracting State may terminate the Agreement at any time after the Agreement enters into force provided that at least 3 months prior notice of termination has been given through diplomatic channels.

Done at —— in duplicate, in the English and —— languages, the two texts having equal authenticity, this —— day of ——, 19——.

FOR THE UNITED STATES OF AMERICA

FOR——

Technical explanation

Either Contracting State may terminate the Agreement at any time after the Agreement enters into force, providing that notice of termination is given through diplomatic channels at least 3 months prior to the date on which the Agreement is terminated.

[continued from p. 34]

from conveyance; from taxes on the acquisition of buildings necessary for the implementation of their investment programme; and

(iii) to a carry forward to the following years of depreciation normally taken into account during the first 3 years.

In addition to the general benefits small and medium sized enterprises (schedule C) are entitled:

(i) to the same exemption as granted to promotional enterprises (for enterprises established outside areas with high industrial concentration the period may be 15 years);

(ii) to an exemption, for maximum 8 years, from taxes on share capital, taxes on credit distribution, registration fees, company tax, tax on industrial and commercial profits.

In addition to the general benefits, enterprises which signed a contract of establishment (schedule D) are entitled:

(i) to the same benefits as granted to priority enterprises;

(ii) to a long term (up to 15 years) stable tax scheme which implies that tax conditions, for all or part of their tax burden, will remain the same as on the day of entry into force of the Schedule and that all new laws and regulations or amendments contrary to the stable tax scheme will not be applicable. However, beneficiaries of the stable tax scheme may request new laws or the right to benefit from such amendments.

In addition to the general benefits or special benefits under one of the Schedules all persons whose industrial products are intended for export may benefit from an exemption from an exemption from export taxes.

4. CONCLUSION

The new Investment Code resembles to a great extent the one it replaces. However, incentives granted under schedules A and B are slightly less beneficial and incentives granted under schedules C and D are slightly more beneficial. Also the definition of investors eligible for the various schedules has been improved. This indicates a policy change in favor of small and medium sized enterprises and very large projects with particular development potential.

Other, more striking, differences between the two Codes are the newly introduced parts defining offenses and penalties which indicate a firmer stance of the Cameroon government towards fraud.

CONFEDERATION FISCALE EUROPEENNE

New President elected

At the Annual General Meeting of the Confédération Fiscale Européenne, which was held in Stuttgart on 9 November 1984, Mr. Michael G. Spofforth was elected to Presidency for a term of 2 years. This is the first time since the CFE was founded that the United Kingdom has provided the President. Mr. Spofforth was born in 1928 and was in 1953 admitted to Associateship of the Institute of Taxation (United Kingdom), advanced to Fellowship in 1964, elected to the Council in 1970 and became a Vice-President in May 1974 when he served as Chairman of the Education Group of the Council. He served as President of the Institute from 1978 to 1980. He assumed Vice-Presidency of the Confédération Fiscale Européeenne in 1982.

The Confédération Fiscale Europénne (C.F.E.) is the association of tax consultants within the European Communities. Its function is to represent the professional interests of tax consultants from the members of the European Communities, in particular to foster relations with the authorities of national and international organs, to pave the way for the standardization of national tax legislation and to influence the shaping of directives on establishment and services in the tax consulting field. It tries to keep the authorities of the European Communities informed of the experience of all those practising the profession in the various fields of taxation, and in particular it wishes to participate in the work of harmonizing national tax legislation.

IFA news

SWEDISH BRANCH

A morning seminar regarding the new Sweden – U.K. tax treaty (signed 30 August 1983) was organized together with the Institute of Foreign Law on 15 May 1984. Guest of Honour was Mr. Yngve Hallin of the Ministry of Finance. Mr. Hallin is head of the Swedish tax treaty negotiating team. The seminar attracted attendances of over 130, approximately half of which were IFA members.

On 10 September 1984 the branch held a meeting for the presentation of the Swedish national reports to the London congress 1985. The national reporters are Mr. Kent Sundqvist, Ministry of Finance (Subject 1: Problems concerning the Assessment and Collection of Tax from Non-Residents), and Mr. Erik Waller, Skandinaviska Enskilda Banken (Subject II: International Double Taxation of Inheritances and Gifts). The meeting was hosted by Svenska Handelsbanken represented by Mr. Karl Einar Rasmusson.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-52 of the January 1985 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

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ALGERIE.
Guide juridique, fiscal et social des entreprises étrangères.
Dossiers internationaux. Seconde édition.
Paris, Editions Francis Lefebvre, 1984. 314 pp., 253 Ffrs.
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Nairobi, The University of Nairobi, 1984. 24 pp.
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Lagos, Oni, Lasebikan & Co. [P.O. Box 2442], 1982. 48 pp.
This booklet examines the general business position in Nigeria, looking in more detail at the tax situation and the investment incentives on offer.
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London, Sweet & Maxwell, 1984. 702 + 545 pp.
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Australian wholesale sales tax in perspective.
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LATIN AMERICA:

TAXATION OF GIFTS AND INHERITANCES

A Practical Approach

By M.A. Gª Caballero

Mr. Gª Caballero holds a law degree (licenciado en derecho) from the University of Oviedo and is a Principal Research Associate at the International Bureau of Fiscal Documentation, Amsterdam.

INTRODUCTION

This article[1] is a country by country[2] survey of the current law on the subject, obtained through a careful analysis of the legislation in force in each country. For those countries currently having no inheritance or gift tax, the law repealing such legislation is cited as well as, wheresoever possible, the date of repeal.

For the convenience of the reader, this survey is in alphabetical order by country. Each survey follows an identical format,[3] thus facilitating easy reference to any particular aspect of inheritance and gift tax, as well as a model for comparative study among the countries.

As will be noted, some countries have an estate tax (such as Puerto Rico and Guyana), some an inheritance tax (such as Venezuela), some a mixed estate and inheritance tax (Belize, Honduras, Paraguay), and some no inheritance or gift tax at all (Argentina, Uruguay and Mexico). Most, but not all, of the countries surveyed have some form of tax on the transfer of gifts inter vivos.

An estate tax is sometimes described as an excise tax levied on the privilege of transferring property at death and is usually measured by the size of the estate.[4] In its pure form, it is usually progressive in relation to the size of the total taxable estate and, logically, is the same regardless of the relation between the deceased and successor or the special characteristics of the recipient of the estate. Several modifications are, however, noticeable in different systems, the most important being the position of the surviving spouse.[5] The estate tax is usually regarded as a debt on the estate and is, therefore, levied on the representatives of the deceased rather than the recipients.

An inheritance tax, by contrast, is levied on the recipients often at highly progressive rates depending on the relationship between the deceased and successor. The rates are usually divided into several classes with lowest rates applied where assets are inherited by the children or surviving spouse.[6]

Gift taxes can perhaps be said to be taxes in lieu of income tax and are normally applied as a general transfer tax comprehending all gifts without taking the relationship between the donor and donee into consideration in other ways than by applying different rates.[7]

Gifts inter vivos made within a certain period, usually 2 to 10 years, of death are often required to be included in the inheritance as an anti-avoidance measure.

Latin America, generally, follows the continental (civil) law tradition with its high regard for the family homestead.[8] In some countries, the homestead is completely exempt from inheritance tax. In others, inheritance law differs widely from this principle and tax is levied on the homestead in the same manner as on other assets.

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[1] For a survey of taxation of inheritances and gifts in Europe, see 24 *European Taxation* 7-8 (1984) at 211.

[2] Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Puerto Rico, Surinam, Uruguay and Venezuela.

[3] This format follows the same general style as *Taxation in Latin America*, a regularly updated loose-leaf handbook published by the International Bureau of Fiscal Documentation and covering most aspects of taxation, both corporate and individual, in Latin America.

[4] *The taxation of transfers of family-held enterprises on death or inter vivos*, Cahiers de Droit Fiscal International, Vol. 64a-b (1979) at 17.

[5] Id. at 19.

[6] Id. at 20.

[7] Id. at 21.

[8] *The Income, Fortune and Estate Tax Treatment of Household Units*, Cahiers de Droit Fiscal International, Vol. 57 (1972), at 316.

ARGENTINA

In Argentina, there is no inheritance (estate) or gift tax levied either at the national or the local level: The former inheritance and gift tax (Impuesto a la Transmisión Gratuita de Bienes) was abolished at the national level by Law 21,282 of 2 April 1976 which also established that the Ministry of the Interior was to instruct the Provinces to abolish any inheritance or gift tax levied at the local level.

Accordingly, gratuitous transfers of property and rights thereon are not subject to any tax in Argentina.

Some of the reasons for the abolition of all inheritance and gift taxes were low fiscal revenues, the creation of taxes on company net worth, individual's net wealth and undivided succession[9] and also because taxation caused by death of the owner was not considered reasonable in view of its effects in respect to the continuity of personal enterprises.[10]

BELIZE

(a) General description

The Belizean estate tax (estates duty) is levied on the deceased's estate passing upon death, in accordance with Ordinance 19 of 15 October 1927, as amended by Ordinances 42/1935, 17/1936, 6/1949, 12/1953 and the Estate Duty (Amendment) Ordinance of 21 June 1980. Bona fide gifts inter vivos are not subject to this tax. The Belizean system is a mixture of an estate tax and an inheritance tax.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate for purposes of the estate tax. Accordingly, taxable property includes:

(i) any Belizean-situs property, including Belizean-registered vessels and rights thereon, of any deceased, regardless of the nationality or residence of transferor and recipient(s);

(ii) foreign-situs shares and interest in a resident company (i.e. registered under the Belizean Companies Ordinance) of any deceased, regardless of the nationality or residence of the holder or recipient(s); and

(iii) any foreign-situs personal property of a deceased person who is resident of Belize, regardless of his/her nationality and of the nationality or residence of the recipient(s).

Notwithstanding (ii) and (iii) above, foreign-situs property is not subject to Belizean estate tax where such property is either situated in Great Britain or Northern Ireland according to their domestic law, or the inheritance or estate tax effectively paid in the country where it is situated is equal to or greater than the Belizean estate tax attributable to such property.

(c) Exempt property

Exempt property includes:

- deceased's personal property situated (or deemed to be situated) in Great Britain or Northern Ireland, according to their domestic law; or in any other foreign country where the death duties therein are equal to or greater than the Belizean estate tax attributable to such property;
- property transferred by bona fide inter vivos gift; and
- a deceased's estate whose net value does not exceed 5,000 Belizean dollars (US$1 = Bz$2).

Thus, if the estate exceeds this amount, no exemption is applicable.

(d) Valuation and deductions

To calculate the value of the deceased's estate, the value of the taxable property in question must be officially assessed. For this purpose, the value of property in general is ascertained through affidavit of the deceased's representative ("to the best of his/her knowledge, information and belief") at fair market prices; or according to the expert's appraisal, where the Belizean registrar is dissatisfied with such valuation.

In establishing the taxable amount of the deceased's estate, the following deductions may be taken:

- reasonable funeral expenses; and
- deceased's debts (including Belizean taxes) and bona fide incumbrances incurred or created by the deceased for full consideration in money value wholly for the deceased's own use and benefit.

(e) Taxable persons and taxable base

For Belizean estate tax purposes, the estate tax is regarded as a debt incurred by the deceased person. Therefore, the deceased's representative (including administrator or executor) is the person liable for this tax. Exceptionally, a Belizean-registered company where the deceased person had shares or rights is liable for the estate tax due on such property.

The estate tax is charged on the taxable base, which is equal to the value of the taxable estate (i.e. gross estate less deductions) where it exceeds Bz$5,000, without any allowances.

However, as an anti-avoidance measure, mortis causa and non-bona fide inter vivos gifts made by the donor within 12 months before death, as well as any inter vivos gifts not followed by an immediate bona fide possession by the donee must be included for purposes of the estate tax.

(f) Tax rates

The estate tax is levied in conformity with the graduated rate table reproduced below. These rates are a function of the deceased's taxable estate and the degree of relationship of the recipients included in one of the two categories below with the deceased person. Note that the rates are not applied per bracket but that the applicable rate is determined by the total value of

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[9] *The taxation of transfers of family-held enterprises on death or inter vivos*, Cahiers de Droit Fiscal International, Vol. 64a-b (1979), at 158.
[10] Id., at 17.

the taxable estate (taxable base). I.e. if the total estate exceeds Bz$50,000 that part to which the persons in Category I are entitled is subject to a flat rate of 12.5% and, if in Category II, to a flat rate of 25%. For this purpose, two categories are distinguished, according to the wording of the law.

Category	*Recipient's relationship*
I	surviving spouse; children/grandchildren; parents;
II	any other persons

Taxable base between Bz$ and Bz$		*Rates I (%)*	*II (%)*
0	5,000	0	0
5,000.1	6,000	1.5	3
6,000.1	10,000	1.75	3.5
10,000.1	15,000	2.5	5
15,000.1	20,000	3.75	7.5
20,000.1	25,000	5	10
25,000.1	30,000	6.25	12.5
30,000.1	35,000	7.5	15
35,000.1	40,000	8.75	17.5
40,000.1	45,000	10	20
45,000.1	50,000	11.25	22.5
50,000.1	—	12.5	25

The tax liability resulting from application of the rate appropriate to either category of recipients is apportioned to each recipient in proportion to the value of his/her interest in the deceased's taxable estate.

(g) Avoidance of double taxation

Belize utilizes the exemption method as a unilateral measure for the avoidance of double taxation for any movable property situated or deemed to be situated in the United Kingdom, according to its domestic law. Such property is not subject to Belizean estate tax. If such property is situated in another foreign country the credit method applies, i.e. no Belizean estate tax is due if the foreign tax is equal to or greater than the Belizean estate tax and in all other cases only the amount by which the Belizean estate tax exceeds the foreign tax is to be paid.

BOLIVIA

(a) General description

The Bolivian current inheritance and gift tax (Impuesto a las Sucesiones Hereditarias y Transmisión Gratuita de Bienes) is governed by an outmoded Law of 5 December 1912, as amended 17 times. Under this system which has not been consolidated, in practice, any recipient is subject to the highest rates, due to the fact that the highest rates within the existing four categories of recipients (10%, 30%, 40% and 90%) are charged on a taxable base exceeding 50,000 pesos (i.e. less than US$6). Within the framework of the ongoing tax reform, the National Congress is currently discussing a modern inheritance and gift tax bill, which will provide for the abrogation of the scattered items of legislation which make up the present inheritance and gift tax.

Because of the likelihood, so necessary indeed, that this bill will be passed and adopted in 1985, this survey will discuss only the *proposed* inheritance and gift tax law.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, taxable property includes:

(i) any Bolivian-situs property of a deceased or donor, regardless of the nationality or residence of transferor and recipient(s); and
(ii) any foreign-situs property of a deceased or donor (regardless of his/her nationality or residence) where the inheritance, bequest or gift is made in Bolivia, regardless of the nationality or residence of the recipient(s).

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of the Bolivian State, public entities, social welfare and educational institutions;
- the family residence where this is the deceased's only real property and its adjusted cadastral value does not exceed 4,000,000 pesos;
- deceased's savings accounts in local banking institutions;
- State bonds; and
- property transferred at death more than once within a 2-year period and retaining the same value.

(d) Valuation and deductions

To calculate the taxable value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, urban real property is assessed at updated cadastral values and rural real property at the value registered in the prior transfer if such transfer occurred within a 2-year period; otherwise according to official appraisal. Vehicles are assessed at their residual value and securities at their book value. The Tax Administration presumes – with a right of rebuttal – that the value of household furnishings and personal belongings is equal to 5% of, and must be added to, the updated cadastral value of the real property concerned.

Special rules apply for determining the value of a usufruct and life annuities. In establishing the taxable amount of the estate apportionable to the recipient(s), the following liabilities may be deducted:

- outstanding debts (including taxes) owed by the deceased and duly substantiated;
- last illness and funeral and related expenses; and
- testamentary related costs.

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is liable to tax. The inheritance or gift tax is levied on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, without any deductions.

However, as an anti-avoidance measure, gifts made in a donor's lifetime to a donee who is a donor's future heir or legatee must be added together for the purpose of determining the beneficiary's taxable base.

(f) Tax rates

The inheritance and gift tax is levied at the progressive rates indicated below. The progression takes into account the recipient's taxable base and his/her relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished, according to the wording of the law:

Category	*Recipient's relationship*
I	spouse; direct ascendent/descendent;
II	brother/sister;
III	uncle/aunt; nephew/niece; son/daughter; parent-in-law;
IV	a more distant relative (such as cousins);
V	a non-relative.

Taxable base (in pesos)		*I (%)*	*II (%)*	*III (%)*	*IV (%)*	*V (%)*
First	5,000,000	2	2.5	3	4	5
Next	5,000,000	4	5	6	8	10
Next	10,000,000	6	7.5	9	12	15
Next	20,000,000	10	12.5	15	20	25
Next	40,000,000	14	17.5	21	28	35
Next	80,000,000	18	22.5	27	36	45
Next	160,000,000	22	27.5	33	44	55
Next	320,000,000	28	35	42	56	70
Next	640,000,000	34	42.5	51	68	85
Over	1,280,000,000	36	45	54	72	90

However, a rebate equal to 20% of the tax liability resulting from the application of the above rates is granted to each recipient (regardless of his/her nationality or residence) who is a deceased's forced heir or legatee and has 4 or more minor children. This rebate is increased to 30% of the tax liability for a recipient who has been judicially declared an incapacitated person.

On the other hand, a non-resident recipient of an inheritance, bequest or mortis causa gift is charged a 50% surcharge on his/her final tax due.

(g) Avoidance of double taxation

Bolivia does not have any unilateral measures for the avoidance of international double taxation. Internal double taxation, however, may be mitigated somewhat by a rule applicable when the same property is transferred by death more than once during a 2-year period. In such a case, the inheritance tax paid on the previous transfer may be subtracted from the tax liability attributable to such property on the second transfer.

BRAZIL

(a) General description

In Brazil, there is no inheritance, estate or gift tax at the federal level nor a true inheritance or gift tax at the local level. However, inheritances, bequests or gifts of real property are subject to a substitute tax at the local level (Imposto sobre a Transmissão de Bens Imóveis e de Direitos a eles relativos), as established in Arts. 35 through 42 of the Federal Tax Code. This local inheritance and inter vivos transfer tax unified and replaced the former inheritance (Imposto Sucessório) and inter vivos transfer tax. It was introduced by the Constitutional Tax Reform through its Amendment 18 of 1 December 1965. Then, the Constitutional Amendment 1 of 17 October 1969 reshaped this tax by establishing that:

(i) it be levied on any transfer (i.e. by inheritance, bequest, gift or for consideration) of real property and rights "in rem" thereon other than guarantees; such tax to be levied by the State where the real property is located; and

(ii) the maximum tax rates applicable in the entire Brazilian territory are to be fixed by Resolution of the Federal Senate.

(b) Maximum tax rates

As a Constitutional limitation to the power of the individual States of the Union to levy this transfer tax, the Federal Senate's Resolution 99 of 16 September 1981 fixed the maximum rate applicable to transfers at death and inter vivos gifts of real property and rights "in rem" thereon at 4% and the maximum rate applicable to transfers for consideration in general at 2%.

(c) Tax rates applicable in the Federal District and São Paulo and Rio de Janeiro States

Accordingly, the Federal District (by virtue of Decree-Law 82 of 26 December 1966 as amended by Law 7,105 of 20 June 1983), and the States of São Paulo (by virtue of Law 3,199 of 23 December 1981) and Rio de Janeiro (by virtue of Decree-Law 5 of 5 March 1975, as amended by Laws 413 of 13 February 1979 and 461 of 30 September 1981) levy the transfer tax on the recipient(s) of real property and rights "in rem" thereon other than guarantees (regardless of the nationality or residence of the transferor or recipients) on the current market value of such property at the rate of 4% for inheritances, bequests and gifts; and at the rate of 2% for transfers for consideration in general. This tax is, however, assessed at the reduced rate of 0.5% on that portion of the transfer value of a dwelling house under the Brazilian Housing Finance System (SFH) which is actually financed through such system.

(d) Avoidance of double taxation

There are no provisions for the avoidance of double taxation. It is, however, legally possible to reduce the 4% transfer tax on inheritances, bequests and gifts of real property to 2% by transferring such property for consideration during the transferor's lifetime.

CHILE

(a) General description

The Chilean inheritance and gift tax (Impuesto a las Herencias, Asignaciones y Donaciones) is levied on the recipient(s), in accordance with Law 16,271 of 10 July 1965, as amended, principally, by Decree-Law 3,545 of 7 January 1981. Most exemptions are governed, however, by special legislation.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, taxable property includes:

(i) any Chilean-situs property of a deceased or donor, regardless of the nationality or residence of the transferor and recipient(s);
(ii) any foreign-situs property of a Chilean deceased or donor; and
(iii) any foreign-situs property of a foreign deceased or donor who acquired that property with Chilean-source resources.

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of the Chilean Treasury, municipalities, public welfare institutions, entities and foundations financed by the State, charities, churches, public museums and educational institutions;
- low cost residences, provided certain requirements are met, and small-size rural property;
- CAR bonds (i.e. readjustable savings bonds of the Central Bank) and long term State bonds;
- death compensation to the beneficiaries of the deceased's life insurance policy;
- the balance on deceased's savings accounts to be used for housing purposes;
- an amount not exceeding 5 vital annual wages[11] in the Metropolitan Region of Santiago on the balance from deceased's savings accounts with the Bank of the State of Chile; and
- remunerations due to a deceased/employee and received by his/her heir(s) or legatee(s).

(d) Valuation and deductions

To calculate the taxable value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, Chilean-situs real property is assessed at the updated cadastral value used for real property tax. However, if such property was acquired by the current transferor within a 3-year period before death, its value is the greater amount of its acquisition price or the value resulting from experts' appraisal. Quoted securities are assessed at their average quoted value over the 6-month period prior to transferor's death or at experts' appraisal. Foreign-situs property is assessed at the value appraised by the Internal Revenue Service (SII). In calculating the value of household furnishings and personal belongings, the SII presumes – with right of rebuttal – that it amounts to 20% of, and has to be added to, the real property concerned. Special rules applying for calculating the value of a usufruct, pensions and annuities.

In establishing the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:

- deceased's last illness and funeral expenses;
- costs incurred by reason of inventory and testamentary procedures;
- debts owed by the deceased (including taxes), which are outstanding at the time of death and do not relate to exempt property;
- liens and obligations imposed on taxable property which effectively reduce its value (e.g. a usufruct, a life annuity); the beneficiary of such liens or obligations are, however, subject to tax on their bequest; and
- mandatory alimonies.

(e) Taxable persons and taxable base

The recipients (i.e. the heir(s), or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property are liable to tax. The inheritance or gift tax is charged on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deduction. Thus, in determining the taxable base of deceased's Category I recipients (see below), each recipient may deduct the first 50 annual tax units[12] on his/her gross portion; a deceased's Category II recipient and a donor's Category I recipient of gifts inter vivos may deduct the first 5 annual tax units. However, as an anti-avoidance measure, gifts made in a donor's lifetime to the same donee (including a donor's future heir or legatee) must be added together for the purpose of determining the beneficiary's taxable base on which the gift or inheritance tax is to be levied.

(f) Tax rates

The inheritance and gift tax is levied at the progressive rates indicated below. The progression takes into account the recipient's taxable base (expressed in annual tax units) and his/her relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished, according to the wording of the law:

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[11] A vital wage is a sum determined by the government and is somewhat higher than the minimum salary to be paid to a wage earner. In 1985, the minimum wage is 8,000 pesos per month.

[12] The 1983 and 1984 tax units are, respectively, 38,076 and 46,572 pesos.

Category	Recipient's relationship
I	spouse; a direct/adoptive descendent/ascendent;
II	brother/sister; nephew/niece; uncle/aunt; first cousin;
III	any other person.

The tax liability of each recipient must be expressed in monthly tax units[13] (based on the tax unit applicable in the month where the deceased's death or donor's gift occur) converted into pesos at the rate of conversion applicable at the time of the tax payment.

Taxable base (in annual tax units)	*I (%)*	*II (%)*	*III (%)*
on the first 80	1	1.2	1.4
on the next 80	2.5	3	3.5
on the next 160	5	6	7
on the next 160	7.5	9	10.5
on the next 160	10	12	14
on the next 160	15	18	21
on the next 400	20	24	28
over 1,200	25	30	35

(g) Avoidance of double taxation

As a unilateral measure for the avoidance of international double taxation, Chile has adopted the ordinary credit method (i.e. the foreign tax paid on foreign-situs property is creditable against and up to the amount of Chilean tax attributable to such property).

Internal double taxation is also mitigated where gifts inter vivos received from the same donor by the same beneficiary are either added together or to the recipient's apportioned amount for purposes of the gift or inheritance tax. Such beneficiary may reduce his/her current tax liability by the amount of tax paid on the prior gift(s).

COLOMBIA

(a) General description

In Colombia, there is no inheritance, estate or gift tax as such. The tax on successions (Impuesto Sucesoral), which was substituted for the former taxes on estates, inheritances and gifts, was abolished by Decree-Law 237 of 4 February 1983. Accordingly, as from 7 February 1983, inheritances, bequests and gifts are treated as capital gains and are subject to a special income tax system (Impuesto Complementario a las Ganancias Ocasionales), in accordance with Decree-Law 2,053 of 30 September 1974, as amended by Law 20 of 16 April 1979 and its Regulatory-Decree 2,595 of 26 October 1979, and the Tax Reform Law 9 of 15 June 1983, implemented by Regulatory-Decree 1,843 of 26 July 1984. This tax is assessed together with and is complementary to the income tax.

(b) Taxable property

Taxable property means property which is includable in the deceased's gross estate or the gift in question for purposes of its apportionment to and subjection of the recipient(s) to tax. Accordingly, for purposes of the capital gain tax on inheritances, bequests and gifts, taxable property includes:

(i) any Colombian-situs property of any deceased or donor, regardless of the nationality or residence of the transferor or recipient;
(ii) any foreign-situs property of any deceased or donor, where the recipient is either a resident Colombian national or a foreigner who is resident of Colombia for more than 6 months; and
(iii) Colombian-situs property only of any deceased or donor, where the recipient is either a non-resident Colombian or foreign individual, or a legal entity regardless of its residence.

(c) Exempt property

Exempt property includes:

- the marriage portion of the surviving spouse in the community property;
- compensation on deceased's life insurance; and
- mortgage bonds issued before 30 September 1974 by the Central Mortgage Bank.

(d) Valuation and deductions

To calculate the value of the apportionable estate or gift for capital gain tax purposes, the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed, in the case of transfers at death, at the value declared by the deceased person in his/her income tax and net wealth tax return for the year immediately before death; and, in the case of inter vivos gifts, at the fiscal value of the property in the year immediately before the act or contract of donation.

In establishing the amount of estate apportionable to the recipient(s) in the form of a capital gain, the following liabilities may be deducted:

- deceased's debts declared in his/her income tax and net wealth tax return for the year immediately before death;
- debts incurred in the inheritance process; and
- debt-claims against the deceased person provided they are duly substantiated.

(e) Taxable persons and taxable base

The individual or corporate recipient (i.e. the heir(s) and legatee(s) of an inheritance or bequest and the donee(s) of an inter vivos gift) of an inheritance, bequest or gift is liable for the payment of this tax. The tax is charged on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deductions. Thus, in the case of transfers at death, the deceased's surviving spouse and each forced heir may deduct, as an allowance, the first 1,400,000 pesos

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[13] The December 1984 and January 1985 tax units are, respectively, 3,881 and 3,928 pesos.

(adjusted annually for inflation); any other individual or corporate recipient of an inheritance or bequest, and each donee in the case of inter vivos gifts may deduct, as an allowance, 20% of the value effectively received. Accordingly, the taxable base of the deceased's surviving spouse and a forced heir is the excess, over the first 1,400,000 pesos of their respective inheritance portion; and the taxable base of any other heir or legatee and of any donee (including donor's spouse and forced heirs) is 80% of their respective inheritance portion or gift.

(f) Tax rates

The final capital gain tax on inheritances, bequests and gifts is levied at flat rates which are different for individual and corporate recipients. In the case of an individual recipient, the capital gain tax is charged on his/her appropriate taxable base at 50% of the rate resulting from dividing his/her basic income tax liability by the total taxable income and then multiplying it by 100; however, such a rate may not be less than 10%. This basic tax liability is calculated either at progressive rates from 4.62% through 49% (for a Colombian individual recipient regardless of his/her residence and for a foreign individual recipient who is a resident of Colombia) or at a 40% and/or 14% flat rate (for a foreign individual recipient who is a non-resident of Colombia).

In the case of a recipient who is a legal person, the tax is charged at 40% where the beneficiary is a Colombian corporation or similar type of company or any foreign entity and at 20% where the beneficiary is a Colombian limited liability company or similar type of company.

In addition to the final capital gain tax charged as above, Colombian-source inheritances, bequests and gifts in favor of non-resident recipients and foreign entities are subject to a surtax on remittances (Impuesto de Remesas) charged at the rate of 1% on the gross after tax payment.

Advance levy on the final tax
Notwithstanding the final capital gain tax calculated as above, each recipient of an inheritance or bequest – whether entirely in cash or partly in cash and partly in kind – and any beneficiary of an inter vivos gift – whether in cash or in kind – is subject to an advance levy at the rate of 5% as follows:

- on the amount in cash exceeding the first 1,400,000 pesos (adjusted annually for inflation) received by the deceased's surviving spouse and each forced heir;
- on 80% of the amount in cash received by any other heir or legatee of the deceased; and
- on 80% of the total value of a gift received by any donee.

(g) Avoidance of double taxation

Colombia has adopted the credit method, applicable only to resident nationals, for the avoidance of international double taxation of inheritances (estates) or gifts; accordingly, the foreign inheritance (estate) or gift tax paid on foreign-situs property by a resident Colombian national may be credited against and up to the amount of the Colombian capital gain tax attributable to such property.

COSTA RICA

In Costa Rica, there is no inheritance (estate) or gift tax. However, gratuitous transfers (i.e. inheritances, bequests and gifts) of Costa Rican-situs property and rights thereon are currently subject to a substitute tax system, as follows:

(i) *The real property transfer tax* (Impuesto sobre los Traspasos de Bienes Inmuebles), as established by Law 6,153 of 21 November 1977.
Property exempt from this tax includes:

- amounts acquired through inheritance, bequest or mortis causa gift by each recipient where the value of his/her own net wealth and the taxable portion together does not exceed 100,000 colones; and
- the homestead (e.g. family's residential house or rural undertaking), where its value does not exceed 300,000 colones. The tax is levied at proportional rates, namely 1.5%, 2.5%, 3.5% or 4%, depending on whether the taxable base in question does not exceed, respectively, ₡400,000, ₡700,000, ₡ 1,000,000 or exceeds ₡1,000,000; and

(ii) *The education and culture stamp duty* (Timbre de Educación y Cultura), introduced by Law 5,923 of 18 August 1976, which abolished the former welfare tax (Impuesto de beneficiencia) and university stamp tax (Impuesto de Timbre Universitario).

DOMINICAN REPUBLIC

(a) General description

The Dominican Republic inheritance and gift tax (Impuesto de Sucesiones y Donaciones) is levied on the recipient(s), in accordance with Law 2,569 of 4 December 1950 as amended, principally, by Law 5,655 of 28 October 1961.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly taxable property includes:

(i) any Dominican-situs property of a deceased or donor, regardless of the nationality or residence of transferor and recipient(s);
(ii) any foreign-situs movable property of a Dominican deceased, regardless of his/her residence or of the nationality or residence of the recipient(s); and
(iii) any foreign-situs movable property of a foreign deceased resident of the Dominican Republic who acquired such property with Dominican-source resources.

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of the Dominican State, public bodies, charities, welfare and public utility institutes recognized by the State;
- death compensation received by the beneficiaries of the deceased's life insurance policy;
- the first 3,000 DR pesos in deceased's savings accounts with domestic institutions plus the interest accrued thereon;
- qualifying investment securities (such as mortgage bonds and bonds issued by the National Mortgage and Construction Bank); and
- the homestead (i.e. an undivided urban or rural real property described as such by public deed or testament, such as the family residence, with or without adjoining tilled land, shop, workshop or agricultural undertaking), provided its value does not exceed 100,000 DR pesos at the time of its entry in the public registry; additionally, the eventual capital appreciation thereafter is also exempt.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, real property is assessed at current market prices or at updated cadastral value. Securities are assessed according to a formula which takes into account profitability and paid-in capital or book value. The Directorate General of Income Tax presumes – with no right of rebuttal – that the value of household furnishings and personal belongings is equal to 10% of, and must be added to, the real property concerned.

Special rules apply for determining the value of a usufruct, or a life annuity.

In establishing the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:

- debts owed by the deceased (other than to the spouse, an heir, legatee, guardian, executor or general administrator) which are outstanding at the time of his/her death and duly substantiated by public of private deed;
- State and local taxes owed by the deceased which are outstanding at the time of his/her death;
- last illness and funeral expenses;
- debts supported by mortgage or pledge on real property located in the Dominican Republic;
- estate inventory and related expenses; and
- salaries, wages and social security payments owed by the deceased/employer which are outstanding at the time of his/her death.

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is (are) liable to tax. The inheritance or gift tax is charged on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deduction. Thus in determining the taxable base of Category I persons (see below), each recipient of a transfer at death may deduct, as an allowance, the first 999 DR pesos on his/her apportioned amount; the deceased's surviving spouse and each Category II and III recipients and each donee of an inter vivos gift may deduct the first 499 DR pesos in calculating his/her taxable base.

However, as an anti-avoidance measure, gifts made in a donor's lifetime to the same donee are subject to tax on the amount exceeding 499 DR pesos.

(f) Tax rates

The inheritance and gift tax is charged at the progressive rates indicated below. The progression takes into account the recipient's taxable base and his/her relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	direct descendent/ascendent;
II	brother/sister;
III	uncle/aunt; nephew/niece; first cousin;
IV	spouse and any other person.

Taxable base (in DR pesos)	*I (%)*	*II (%)*	*III (%)*	*IV (%)*
First 2,000	1	3	6	8
Next 3,000	2	4	7	10
Next 5,000	3	5	8	12
Next 10,000	4	6	10	14
Next 20,000	5	7	12	15
Next 20,000	6	8	13	17
Next 20,000	7	10	15	19
Next 20,000	8	12	18	22
Next 25,000	9	13	20	24
Next 25,000	10	14	21	25
Next 50,000	11	15	22	26
Next 100,000	12	16	23	28
Next 100,000	13	17	24	29
Next 100,000	15	19	25	30
Over 500,000	17	21	27	32

In addition to the basic rates in Categories I through IV, a 50% surcharge is levied on inheritances, bequests and mortis causa gifts to the benefit of a recipient who is a non-resident of the Dominican Republic, including persons who have been absent (except for official or other duly justified reason) for one or more years before the transferor's death.

(g) Avoidance of double taxation

The Dominican Republic does not have any unilateral measures for the avoidance of international or internal double taxation of inheritances or gifts.

ECUADOR

(a) General description

The Ecuadoran inheritance and gift tax (Impuesto sobre Herencias, Legados y Donaciones) is levied on the recipient(s), in accordance with Decree-Law of 1 December 1961, as amended. However, inter vivos gifts received by donees who are not next of kin to the donor are subject to an additional tax (alcabala, i.e. transfer tax) on property transfers.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, for purposes of inheritance or gift tax, taxable property includes:

(i) any Ecuadoran-situs property of a deceased or donor, regardless of the nationality or residence of transferor and recipient(s);

(ii) any foreign-situs debt-claims either guaranteed by Ecuadoran-situs real property or payable in Ecuador or arising from contracts made in Ecuador;

(iii) foreign-situs money deposits and securities of an Ecuadoran deceased or donor, regardless of his/her residence and of the nationality or residence of the recipient(s); and

(iv) *(only for purposes of establishing the progressive tax charged to each recipient)* any foreign-situs property (other than (ii) and (iii) above) of a deceased who is either an Ecuadoran (regardless of his/her residence) or a foreigner resident of Ecuador. Thus the Ecuadoran tax is not charged on foreign-situs property other than (ii) and (iii) above.

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of Ecuadoran public bodies and institutions and private educational, social welfare, cultural, artistic and scientific research institutes or activities and institutions officially declared of public interest or social utility;
- death compensation received by deceased's forced heirs (including State pensions and life insurance payments); and
- the first 100,000 sucres on deceased's share in savings and credit housing investment funds.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, the value of the property is established, in general, according to official experts' appraisal or at market prices or at updated cadastral value. Special rules apply for determining the value of a usufruct and life annuities.

In establishing the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:

- the marriage portion of the surviving spouse;
- last illness, funeral, inventory and related expenses;
- debts owed by the deceased (including taxes) outstanding at the time of death and duly substantiated; and
- executor's fees on an amount not exceeding 6% of the apportionable estate in question.

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is (are) liable to tax. The inheritance or gift tax is charged on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deductions. Thus in determining the taxable base of a deceased's heir or of a donor's beneficiary, each recipient may deduct, as an allowance, the first 20,000 sucres; the deduction is equal to the first 5,000 sucres for each recipient who is a deceased's legatee and to the first 150,000 sucres where the recipient is a workers' association established as a legal entity.

However, as an anti-avoidance measure, gifts made in a donor's lifetime to the same donee within a 10-year period before death must be added together for the purpose of determining the beneficiary's taxable base.

(f) Tax rates

The basic inheritance and gift tax rates (see table below) are progressive and depend on each recipient's taxable base and his/her relationship with the deceased or donor in question. For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	spouse; child;
II	grandchild/parent;
III	a further descendent/ascendent;
IV	brother/sister
V	nephew/niece; uncle/aunt;
VI	first cousin;
VII	others.

Taxable base (in sucres)	*I (%)*	*II (%)*	*III (%)*	*IV* (%)*	*V* (%)*	*VI* (%)*	*VII* (%)*
First 20,000	6	6.6	7.2	10.8	14.4	18	24
Next 20,000	6.5	7.15	7.8	11.7	15.1	19.5	26
Next 40,000	7.5	8.25	9	13.5	18	22.5	30
Next 60,000	8.5	9.35	10.2	15.3	20.4	25.5	34
Next 60,000	9.5	10.45	11.4	17.1	22.8	28.5	38
Next 100,000	10.5	11.55	12.6	18.9	25.2	31.5	42
Next 200,000	11.5	12.65	13.8	20.7	27.6	34.5	46
Next 200,000	13	14.3	15.6	23.4	31.2	39	52
Next 300,000	15	16.5	18	27	33.2	45	60
Next 1,000,000	18	19.8	21.6	32.4	43.2	54	72
Next 1,000,000	22	24.2	26.4	39.6	52.8	65	85
Next 1,000,000	26	28.6	31.2	43	55	|	|
Next 1,000,000	30	33	36	|	|	|	|
Over 5,000,000	35	38.5	42	↓	↓	↓	↓

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* The total tax liability of each recipient (within categories IV through VII), resulting from the application of the appropriate progressive rates is limited to: 35%, 40%, 50% and 65% of his/her respective taxable base.

However, there are 2 types of tax rebates which are available on account of recipient's family circumstances and age. An eligible recipient may elect one or the other, but not both of the following:
- on account of family circumstances, each heir and donee who is either married or has 2, 3, 4, 5 or 6 or more children (whether living or represented by their descendents) is entitled to a rebate (calculated on the tax liability resulting from application of the appropriate progressive rates) equal, respectively, to 5%, 10%, 20%, 30%, 40% or 50%; or
- on account of age, each heir and donee who is either between 40 and 50 years old, or over 50, 60, 65, 70 or 75 years of age is entitled, respectively, to a rebate equal to 5%, 10%, 15%, 20%, 25% or 30% of the tax liability resulting from application of the appropriate progressive rates. Notwithstanding these tax rebates, gifts inter vivos where the donee is not a forced heir of the transferor are subject to an internal double taxation, namely the (inheritance and) gift tax levied at progressive rates, and the "alcabala" (municipal tax on transfers for consideration of real property and vessels, which is levied at progressive rates of 2%, 3% and 4%) reduced by 50%. Furthermore, in addition to the tax liability resulting from application of above tax rates and rebates, the following surcharges are imposed:

(i) a 20% surcharge (but the total tax due is limited to 65% of his/her taxable base) on the final tax due by a recipient who – within each category – is an in-law of the deceased/donor (e.g. a son/daughter-in-law or a brother/sister-in-law are subject to tax, according to Categories I and IV, respectively, plus 20% surcharge); and

(ii) a 5% surcharge (but this surcharge is limited to 70% of the final tax liability) calculated on the value of a recipient's own wealth, according to fixed slices; such as on each slice of: 60,000 sucres (for an unmarried, divorced or widowed recipient with no more than one child), 80,000 sucres for a married recipient with no children), and 100,000 sucres for a married recipient with one child); the slice used in calculating the 5% surcharge is increased by 20,000 sucres for each second, third, and successive child of a recipient and the surcharge amount is then limited to 60% of the final tax liability.

(g) Avoidance of double taxation

Ecuador does not have any unilateral measures for the avoidance of international double taxation. Internal double taxation occurs in the case of inter vivos gifts received by a donee who is not a donor's forced heir, but is, however, somewhat mitigated by a rule applicable when the same property is transferred by a gift inter vivos or at death more than once within a 5-year period. In such a case, there is either no gift or inheritance tax on the current recipient (if there is no excess value in such property) or the tax is reduced by 25%, 20%, 15%, 10% or 5%, depending on whether the second transfer occurs in the first or the second part of the first year after the prior transfer or within a 2, 3, 4 or 5-year period, respectively. This rebate, however, cannot be used together with the rebate granted on account of age (see (f)(ii) above).

EL SALVADOR

(a) General description

The Salvadoran inheritance tax (Gravamen de las Sucesiones) and gift tax (Impuesto sobre Donaciones) is levied at progressive rates on recipients other than non-resident aliens and at flat rates on the recipients who are non-resident foreigners, in accordance with the Inheritance Tax Decree 122 and Gift Tax Decree 123, both of 8 November 1974. However, inter vivos gifts which, for whatever reason (such as exemption) are not subject to gift tax then become liable to the "alcabala" tax (i.e. transfer tax) and any gift inter vivos is subject to an additional levy.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, taxable property includes only Salvadoran-situs property of a deceased or donor, regardless of the nationality or residence of transferor and recipient(s).

(c) Exempt property

Exempt property includes, inter alia:
- bequests and gifts to the benefit of the Salvadoran State's public bodies, welfare institutions, institutes financed by the State, religious entities and mortis causa trusts for social, cultural and welfare purposes;
- the homestead (i.e. deceased's residence or rural real property registered as a homestead and transferred as undivided real property to the deceased's next of kin);
- death benefits and compensation on deceased's life insurance received by the heirs or legatees;
- the first 6,000 colones from deceased's capital savings and insurance funds;
- deceased's local bank accounts;
- mortgage bonds (including premiums and interest thereon) from the Salvadoran Mortgage Bank; and
- listed public securities specifically exempt from any tax.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed at market prices. Special rules apply for determining the value of a usufruct and life rents.

In establishing the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:

- deceased's debts which are outstanding at the time of death and are duly substantiated;
- State and local taxes outstanding at the time of death;
- the first 4,000 colones of last illness expenses and the first 2,000 colones of funeral and related expenses duly substantiated;
- testamentary and related expenses; and
- the liens and obligations imposed on inter vivos gifts of property (e.g. usufruct, life rent).

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is (are) liable to tax. The inheritance or gift tax is charged on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deduction. Thus in determining the taxable base of any deceased's or donor's beneficiary, each recipient may deduct, as an allowance, the first 6,000 colones.

However, as an anti-avoidance measure, gifts made in a donor's lifetime to the same donee (including a donor's future heir or legatee) must be added together for the purpose of determining the beneficiary's taxable base on which the inheritance tax is to be charged.

(f) Tax rates

The inheritance and gift tax is levied at the progressive rates indicated below under "R" to a Salvadoran (regardless of his/her residence) and a foreign recipient resident of El Salvador (taking into account his/her taxable base and relationship with the deceased or donor) and at the unified flat rates indicated below under "F" to a foreign recipient who is non-resident of El Salvador on the amount exceeding 6,000 colones (taking into account only his/her relationship with the deceased or donor). For this purpose, the following categories of recipients are distinguished, according to the wording of the law:

Category	*Recipient's relationship*
I	spouse; direct/adoptive descendent/ascendent;
II	brother/sister; child/parent-in-law;
III	uncle/aunt; nephew/niece;
IV	first cousin;
V	any other.

Taxable base (in colones)	*I (%)*		*II (%)*		*III (%)*		*IV (%)*		*V (%)*	
	"R"	*"F"*	*"R"*	*"F"*	*"R"*	*"F"*	*"R"*	*"F"*	*"R"*	*"F"*
First 6,000*	0		0		0		0			
Next 2,000	1.6	25	2.6	30	6.6	40	9.6	45	12.6	50
Next 2,000	1.8	„	2.8	„	6.8	„	9.8	„	12.8	„
Next 5,000	2	„	3	„	7	„	10	„	13	„
Next 5,000	2.5	„	3.5	„	7.5	„	10.5	„	13.5	„
Next 5,000	3	„	4	„	8	„	11	„	14	„
Next 5,000	3.5	„	4.5	„	8.5	„	11.5	„	14.5	„
Next 5,000	4	„	5	„	9	„	12	„	15	„
Next 5,000	4.5	„	5.5	„	9.5	„	12.5	„	15.5	„
Next 5,000	5	„	6	„	10	„	13	„	16	„
Next 5,000	5.5	„	6.5	„	11	„	14	„	17	„
Next 10,000	6	„	7	„	12	„	15	„	18	„
Next 10,000	6.5	„	7.5	„	13	„	16	„	19	„
Next 10,000	7	„	8	„	14	„	17	„	20	„
Next 10,000	7.5	„	8.5	„	15	„	18	„	21	„
Next 10,000	8	„	9	„	16	„	19	„	22	„
Next 100,000	9	„	10.5	„	19	„	22	„	25	„
Next 100,000	10	„	12	„	22	„	25	„	28	„
Next 100,000	11	„	13.5	„	25	„	28	„	31	„
Next 200,000	12	„	15.5	„	28	„	31	„	34	„
Next 200,000	13.5	„	17.5	„	32	„	34	„	37	„
Next 200,000	16	„	20	„	35	„	38	„	40	„
Over 1,000,000	20	„	23	„	38	„	41	„	50	„

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* However, a donee of a gift inter vivos is subject to 1% "alcabala" tax plus 0.5% additional levy on the exempt amount. Moreover, where the value of a gift inter vivos exceeds the exempt amount, and the exempt amount is subject to 1% "alcabala" tax, the excess is subject to gift tax at progressive or flat rates (depending on who the recipient is) and the entire value of the gift is subject to the 0.5% additional levy.

Nevertheless, the liability resulting from application of the inheritance tax rates (i.e. in the case of a transfer at death) may be reduced by a 50% rebate where the recipient is the deceased's surviving spouse, a minor or a permanently handicapped person and both his/her taxable base and personal net wealth do not exceed 25,000 colones each.

(g) Avoidance of double taxation

El Salvador does not have any unilateral measures for the avoidance of international double taxation. However, such taxation is avoided pursuant to the rule that only transfers of Salvadoran-situs property are subject to tax. Internal double taxation occurs in the case of gifts inter vivos (see * above); but it is mitigated somewhat where the same property acquired through a gift inter vivos must be added in calculating the taxable base for inheritance tax purposes. In such a case, the gift tax may be credited against the inheritance tax attributable to that property.

GUATEMALA

(a) General description

The Guatemalan inheritance and gift tax (Impuesto de Herencias, Legados y Donaciones) is levied on the recipient(s), in accordance with Decree 431 of 18 November 1947, implemented by a Presidential Regulation of 3 March 1954, both as amended.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly,

(i) taxable property includes:

- Guatemalan-situs real property of a deceased, regardless of the nationality or residence of transferor and recipient(s); and movable property if the inheritance process is opened in Guatemala; and

- any foreign-situs real property of a deceased, where the inheritance process is opened in Guatemala; and movable property, where the deceased acquired it with Guatemalan-source resources; and

(ii) for purposes of the gift tax, taxable property includes:

- Guatemalan-situs movable property of any donor, regardless of his nationality or residence or of the nationality or residence of the recipient(s); and
- any property, regardless of its location, of a donor where the act or contract of donation is made in Guatemala.

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of the Guatemalan State, public bodies and universities, churches, social welfare and educational institutions declared to be of public interest;
- an amount not exceeding 300 quetzales per year and donee in inter vivos gifts.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed at market prices or according to official experts' appraisal. Special rules apply for determining the value of a usufruct and life annuities.

In establishing the taxable amount of the estate apportionable to the recipient(s), the following liabilities may be deducted:

- debts owed by the deceased and liens and obligations imposed by the transferor on his/her property outstanding at the time of death and duly substantiated;
- last illness and funeral expenses, professional fees and testamentary expenses;
- State and local taxes due by the deceased and outstanding at the time of death;
- compensation received by the heirs on account of the death and up to 1,000 quetzales paid by savings and special death insurance funds;
- amounts received out of life insurance policies;
- mandatory alimonies;
- the marriage portion of the surviving spouse;
- salaries and wages due to the deceased not exceeding 1,000 quetzales;
- copyright royalties;
- public bonds where specifically exempt;
- money deposits with Guatemalan resident banking and savings institutions.

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is (are) liable to tax. The inheritance or gift tax is charged on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deduction. Thus in determining the taxable base of the recipient(s), each beneficiary of a transfer at death may deduct, as an allowance: the first 500 quetzales (1000 quetzales if the recipient is less than 12 years old) for recipients in Categories I and II (see below), or the first 300 quetzales for recipients in Categories III through VII.

However, as an anti-avoidance measure, gifts made in a donor's lifetime to the same donee exceeding 300 quetzales per each calendar year must be added together for the purpose of determining the beneficiary's taxable base on which the tax is to be levied.

(f) Tax rates

The inheritance and gift tax is levied at the progressive rates indicated below. The progression takes into account the recipient's taxable base and his/her relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	spouse; child;
II	direct ascendent and grand-/greatgrand-child;
III	brother/sister;
IV	nephew/niece; uncle/aunt;
V	first cousin;
VI	in law/step relative;
VII	others.

Taxable base (in quetzales)	*I* (%)*	*II* (%)*	*III* (%)*	*IV* (%)*	*V* (%)*	*VI* (%)*	*VII* (%)*
First 50,000	1	2	3	5	7	9	12
Next 50,000	2	3	4	6	9	10	14
Next 100,000	3	4	5	7	10	11	16
Next 100,000	4	5	6	8	11	12	18
Next 200,000	5	6	7	9	12	13	20
Over 500,000	6	7	8	10	13	14	25

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* In addition to the rates applicable to recipients in Categories I through VII, in the case of foreign-situs money deposits held by a deceased or donor, the balance thereon is subject to a 3% (penalty) charge which must be paid by the recipients.

(g) Avoidance of double taxation

Guatemala has a unilateral measure for the avoidance of international double taxation consisting of the credit method, according to which foreign tax paid is creditable against the Guatemalan tax up to the amount of Guatemalan tax attributable to the pertinent foreign-situs property.

GUIANA (FRENCH)

French Guiana is a French Overseas Department. Accordingly, the taxation of inheritances and gifts in French Guiana (Droits de Succession et de Donation) is governed by the French General Tax Code, as amended by Law 83-1179 of 29 December 1983. (See 24 *European Taxation* 1984, 7/8 at 224.)

GUYANA (COOPERATIVE REP. OF)

(a) General description

The Guyanese estate tax (estate duty) is charged on the deceased's estate passing upon death, in accordance with Estate Duty Act 4 of 26 February 1898, as amended numerous times. The latest amendment was introduced by Law Revision Act 11 effective on 18 May 1983. Inter vivos gifts of real property and rights or interest thereon are subject to a transfer tax, in accordance with Law Revision Act 4 of 23 September 1972.

(b) Taxable property

Taxable property means property includable in the gross estate or gift in question for purposes of the estate or transfer tax. Accordingly, in the case of the estate tax, taxable property includes:

(i) any Guyanese-situs property, including Guyanese-registered vessels and rights thereon, of any deceased, regardless of the nationality or residence of the transferor and recipient(s); and

(ii) any foreign-situs personal property of a deceased person who is resident of Guyana, regardless of his/her nationality and of the nationality or residence of the recipient(s); and, in the case of inter vivos gifts (i.e. transfer tax), taxable property includes Guyanese-situs real property and rights or interest thereon.

(c) Exempt property

Exempt property includes:

- the first 25,000 Guyanese dollars (US$1 = G$3.75) of a deceased person killed while in official active service (or who died within a 3-year period as a consequence of injuries caused by operations of war) where the deceased's estate passes to the surviving spouse, direct descendents/ascendents, brothers/sisters or nephews/nieces; and the property of such deceased person, where passed on again on the death of any of the qualifying recipients;
- a deceased's estate whose value does not exceed G$500; and
- property transferred by bona fide inter vivos gifts.

(d) Valuation and deductions

To calculate the value of the deceased's estate or of the gift, the value of the taxable property in question must be officially assessed. For this purpose, the value of property in general is ascertained through affidavit of the deceased's representative – executor or heir – ("to the best of his/her knowledge, information and belief") at fair market prices; or according to an expert's appraisal, where the Guyanese Commissioner of Inland Revenue is dissatisfied with the representative's estimate. In the case of inter vivos gifts of real property, the true value of such property must be stated in the deed in question; otherwise, according to a sworn valuation of a competent appraiser.

In establishing the amount of the deceased's estate, the following deductions may be taken:

- reasonable funeral expenses; and
- deceased's debts (including Guyanese taxes other than the estate tax and the inheritance or estate tax charged by a foreign country other than a territory of the Commonwealth on property located therein) and bona fide incumbrances incurred or created by the deceased for full consideration wholly for deceased's own use and benefit.

(e) Taxable persons and taxable base

For estate tax purposes, the estate tax is regarded as a debt incurred by the deceased person. Accordingly, the deceased's representative (i.e. the executor or the heir) is the person liable for the payment of this tax. In the case of gifts of Guyanese-situs real property, the donor jointly with the donee is liable for the payment of the transfer tax.

The estate tax is charged on the taxable base of a deceased's estate and it is equal to the value of the taxable estate (i.e. gross estate less deductions) where the resulting amount exceeds G$500, in general, without any deductions. However, where the estate of a deceased person passes on to his/her next of kin (i.e. surviving spouse, direct descendents/ascendents, brothers/sisters, nephews/nieces) and such deceased person is a victim of war or died in official active service, the first G$25,000 of the taxable estate may be deducted as a lump sum in establishing the deceased's taxable base.

As an anti-avoidance measure, mortis causa and non bona fide gifts inter vivos made by the donor within a 5-year period before death, as well as any inter vivos gifts not followed by an immediate bona fide possession and enjoyment of the donee, must be included for purposes of the estate tax. In the case of gifts of real property, the transfer tax is charged ad valorem.

(f) Tax rates

The estate tax is levied in conformity with the rate table below. These rates take into account the taxable base in question. Note that the rates are not applied per bracket but that the applicable rate is determined by the total value of the taxable estate (tax base). However, the tax is assessed at 50% of these rates either

(i) on the first G$25,000 passing to each qualifying recipient (i.e. deceased's surviving spouse, unmarried daughter, minor or severely handicapped child or such child's surviving spouse); and

(ii) on the excess over the first G$25,000 (which is exempt) of the taxable base of a qualifying deceased (i.e. a person killed while in official active service or who died within a 3-year period after having suffered injuries caused in operations of war) passing to his/her forced heirs (i.e. surviving spouse, direct descendents/ascendents, brothers/sisters and/or nephews/nieces).

Inter vivos gifts of Guyanese-situs real property and rights or interest thereon are subject to transfer tax at the rate of 2%.

Taxable base brackets: between G$	*and G$*	*Proportional rate* (%)*
—	500	0
500.1	2,500	0.5
2,500.1	5,000	1
5,000.1	10,000	2
10,000.1	25,000	3
25,000.1	50,000	5
50,000.1	75,000	7.5
75,000.1	100,000	10
100,000.1	125,000	12
125,000.1	150,000	14
150,000.1	175,000	16
175,000.1	200,000	18
200,000.1	250,000	20
250,000.1	300,000	22
300,000.1	350,000	24
350,000.1	400,000	26
400,000.1	450,000	28
450,000.1	500,000	30
500,000.1	600,000	32
600,000.1	1,000,000	35
1,000,000.1	1,500,000	40
1,500,000.1	2,000,000	45
2,000,000.1	4,000,000	50
4,000,000.1	5,000,000	55
5,000,000.1	—	60

* However, the estate tax liability resulting from application to the taxable base of the rate therein may not exceed the sum of the tax liability calculated on the upper limit of the immediately preceding taxable base plus the amount by which the taxable base in question exceeds such upper limit. If, for example, the taxable base is G$4,050,000 and at 55%, the tax due should be G$2,227,500. The *actual* tax limitation would be G$2,050.000 (instead of G$2,227,500), i.e. 50% of G$4,000,000, the preceding upper limit, plus the G$50,000 excess over the G$4,000,000 (marginal rate relief).

(g) Avoidance of double taxation

The Cooperative Republic of Guyana has adopted, as a unilateral measure for the avoidance of international double taxation of foreign-situs property, the credit method with regard to property situated in any Commonwealth territory (i.e. the death duty paid in such territory on property located therein is creditable against and up to the amount of the Guyanese estate tax attributable to such property), and the deduction method with regard to property situated in any other foreign country (i.e. the foreign tax paid may be deducted in calculating the value of the taxable estate concerned). Internal double taxation is either avoided (where property of a war victim or someone who died while in official active service and passed to his/her forced heir is passed on again on death of such heir) by granting an exemption of such property or tax refund if the estate tax is already paid; or mitigated (where the same property passes on the death of a recipient within a 5-year period) by reducing the estate tax attributable to such property by 50%, 40%, 30%, 20% or 10%, depending on whether the second death occurs within 1, 2, 3, 4 or 5-year period after the previous death.

HONDURAS

(a) General description

The Honduran inheritance and gift tax (Gravamen sobre Herencias, Legados y Donaciones) is levied on the amount by which the inheritance, bequest or gift in question exceeds 10,000 lempiras, in accordance with Decree 67 of 15 February 1938, implemented by Presidential Resolution 574-A of 31 December 1955, both as amended. The Honduran inheritance system is a mixture of an estate tax and an inheritance tax.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, taxable property includes any Honduran-situs property of a deceased or donor, regardless of the nationality or residence of transferor and recipient(s).

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of Honduran municipalities and public entities financed by the State; welfare and educational institutions;
- mandatory alimonies;
- the wife's endowment portion;
- any property which has been subject to inheritance or gift tax within a one year period;
- death compensation paid by Honduran life insurance institutions;
- qualifying public bonds specifically exempt from any tax; and
- an inheritance, bequest or gift whose total value, as a whole, does not exceed 10,000 lempiras.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed at fair market prices.

In establishing the amount of estate apportionable to the recipient(s), any liabilities, liens and obligations which are imposed by the transferor on or exist in the taxable property in question may be deducted, provided they are duly substantiated.

(e) Taxable persons and taxable base

The recipients (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is (are) liable for the payment of the tax. However, the inheritance or gift tax is levied on the taxable base of each category of recipients (i.e. on the total amount received by each group of heirs, legatees or donees). This taxable base is equal to the amount by which the gross estate (or gift) apportioned as a whole to a category of recipients exceeds 10,000 lempiras (even if the portion of each recipient within such a category is less than that amount), without any further deductions.

(f) Tax rates

The inheritance and gift tax is levied at the flat rates indicated below on the amount of apportionable estate as a whole or gift exceeding 10,000 lempiras. The gradually increasing flat rates depend on the different categories of groups of recipients (see below), rather than on each recipient's relationship with the deceased or donor. Then, the tax liability resulting from application of the fixed rate for each group category is to be paid by each recipient, according to his/her portion, even if such a portion is less than 10,000 lempiras.

For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	married children;
II	spouse; married parents; married grand/greatgrandchildren;
III	married grand/greatgrand parents; married brothers/sisters;
IV	nephews/nieces; uncles/aunts; cousins;
V	step/in-law relatives;
VI	any other (excluding foreigners non-resident of Honduras);
VII	foreigners non-resident of Honduras (including resident foreigners who leave Honduras).

Taxable base (in lempiras)	*I (%)*	*II (%)*	*III (%)*	*IV (%)*	*V (%)*	*VI (%)*	*VII (%)*
First 10,000	0	0	0	0	0	0	0
Over 10,000	1	2	3	5	8	10	20

(g) Avoidance of double taxation

Honduras does not have any unilateral measures for the avoidance of international double taxation. However, such taxation is generally avoided by the Honduran system as only Honduran-situs property and rights thereon are subject to this tax. Internal double taxation is mitigated with regard to real property which has already been subject to inheritance or gift tax in a period of less than one year. In such a case, such property is not includable in the estate in question and therefore not subject to a further tax.

MEXICO

In Mexico, there is no inheritance (estate) or gift tax levied either at federal or local level. The former federal tax on inheritances and bequests (Ley Federal del Impuesto sobre Herencias y Legados) was abolished at the federal level and for the Federal District by a law of 1 January 1962; and the former federal tax on gifts (Ley Federal del Impuesto sobre Donaciones) was abolished at the federal level and for the Federal District by a law of 1 January 1964. The other 30 states of the federation also abolished their respective inheritance and gift taxes. Moreover, the tax on acquisitions of real property and rights thereon, whether for consideration or gratuitously (i.e. by inheritance, bequest or gift), is not a substitute inheritance and gift tax, but a tax which was substituted for the former stamp tax law of 24 December 1975 with effects as from 1 January 1980.

Therefore, inheritances, bequests and gifts are not subject to any tax in Mexico.

NICARAGUA

(a) General description

The Nicaraguan inheritance, bequest and gift tax (Impuesto sobre Herencias y Legados) is levied on the recipient(s), in accordance with Decree-Law 724 of 30 June 1962 as amended, principally by Decree-Law 759 of 29 September 1962 in the case of transfers at death and in accordance with Decree-Law 724 of 30 June 1962 as amended, principally by Decree-Law 764 of 29 September 1962, in the case of inter vivos gifts of real property and rights thereon (Impuesto sobre Transmisiones de Derechos Relativos a Bienes Inmuebles).

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, for purposes of inheritance or gift tax, taxable property includes:

(i) any Nicaraguan-situs property (including securities issued by Nicaraguan companies) of any deceased, regardless of the nationality or residence of transferor and recipient(s);

(ii) foreign-situs movable property of a Nicaraguan deceased; and

(iii) any Nicaraguan-situs real property and rights thereon transferred in a donor's lifetime by gift, regardless of the nationality or residence of donor/donee.

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of Nicaraguan public bodies and scientific, charitable, educational and social welfare institutions;
- mandatory alimonies;
- death compensation (including life insurance payments) received by deceased's heirs; and
- an amount not exceeding 5,000 cordobas (₡) on the value of household furnishings and personal belongings.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed in accordance with official experts' appraisal.

In establishing the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:

- deceased's debts outstanding at the time of death and duly substantiated;
- mortgages on Nicaraguan-situs real property;
- State and local taxes owed by the deceased at the time of death;
- an amount not exceeding ₡2,500 for death and funeral expenses; and
- fees owed to attorneys or other professional practitioners involved in the inheritance process.

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and donee(s) of a gift) of taxable property is (are) liable to tax. The inheritance or gift tax is levied on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deduction. Thus in determining the taxable base of any person in Categories I through IV (see below), each recipient may deduct, as an allowance, the first ₡5,000.

However, as an anti-avoidance measure, gifts made in a donor's lifetime to the same donee within a 10-year period and with no more than a 5-year separation between them must be added together for the purpose of determining the beneficiary's taxable base.

(f) Tax rates

The inheritance and gift tax is levied at the progressive rates indicated below. The progression takes into account the recipient's taxable base and his/her relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	spouse; direct/adoptive descendent/ascendent;
II	brother/sister;
III	nephew/niece; uncle/aunt;
IV	any other person.

Taxable base (in cordobas)	*I (%)*	*II (%)*	*III (%)*	*IV (%)*
First 5,000	0	0	0	0
Next 45,000	3	7	10	14
Next 50,000	4	8	11.5	16
Next 50,000	5	9	13	18
Next 50,000	6	10	14.5	20
Next 50,000	7	11	16	22
Next 50,000	8	12	17.5	24
Next 50,000	9	13	19	26
Next 50,000	10	14	20.5	28
Next 50,000	11	15	22	30
Next 50,000	12	16	23.5	32
Over 500,000	13	17	25	34

In addition to the rates applicable to persons in Categories I through IV, any recipient of an inheritance, bequest or mortis causa gift is subject to a 10% surcharge; and, where the recipient is a foreigner who is a non-resident of Nicaragua, to a further surcharge equal to 100% of the tax liability.

(g) Avoidance of double taxation

Nicaragua does not have any unilateral measures for the avoidance of international or national double taxation of inheritances or gifts.

PANAMA

(a) General description

The Panamanian inheritance and gift tax (Impuesto sobre Asignaciones Hereditarias y Donaciones) is charged to the recipient(s), in accordance with Arts. 813-839 of Law 8 of 27 January 1956 (Fiscal Code), as amended.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, taxable property includes any Panamanian-situs property of a deceased or donor, regardless of the nationality or residence of transferor and recipient(s).

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of Panamanian public bodies, social welfare and educational institutions;
- real estate situated in "special" tourist zones;
- individual portions of inheritance, bequest or gift where these do not exceed 1,000 balboas per recipient;
- compensation paid in consideration of the deceased's life insurance;
- death subsidies due upon the death of the holder; and
- an apportionable estate not exceeding 30,000 balboas in value.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed at fair market prices. Special rules apply for determining the value of a usufruct or a life annuity.

In establishing the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:

- outstanding debts (other than in favor of relatives) existing at the moment of death, which are substantiated by documentary evidence;
- portion of community property belonging to the surviving spouse;
- compulsory alimonies; and
- funeral and related expenses up to 500 balboas.

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is (are) liable to tax. The inheritance or gift tax is levied on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of estate (or gift) apportioned to the pertinent recipient, as reduced by the appropriate deduction. Thus, in determining the taxable base of any person, regardless of his/her relationship with the deceased or donor, each recipient may deduct, as an allowance, the first 1,000 balboas.

However, as an anti-avoidance measure, gifts inter vivos made by a donor to the same donee within a 5-year period and exceeding 1,000 balboas must be added together for purposes of determining the beneficiary's taxable base.

(f) Tax rates

The inheritance and gift tax is levied at the progressive rates indicated below. The progression takes into account the recipient's taxable base and his/her relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	spouse; direct/adoptive descendent;
II	direct ascendent;
III	brother-stepbrother/sister; son/daughter-in-law;
IV	uncle/aunt; nephew/niece;
V	first cousin; child of a son/daughter-in-law;
VI	any other person.

Taxable base (in balboas)	*I* (%)*	*II* (%)*	*III* (%)*	*IV* (%)*	*V* (%)*	*VI* (%)*
First 5,000	4	4.25	4.5	4.75	5	5.5
Next 5,000	5	5.25	5.5	5.75	6	6.5
Next 5,000	6.25	6.5	6.75	7	7.25	7.75
Next 5,000	7.5	7.75	8	8.25	8.5	9
Next 10,000	9.5	9.75	10	10.25	10.5	10.75
Next 20,000	11.75	12	12.25	12.5	12.75	13.25
Next 25,000	14	14.25	14.5	14.75	15	15.5
Next 25,000	16.25	16.5	16.75	17	17.25	17.75
Next 50,000	19	19.25	19.5	19.75	20	20.5
Next 50,000	21.75	22	22.25	22.5	22.75	23.25
Next 100,000	25.25	25.5	25.75	26	26.25	26.75
Next 100,000	28.75	29	29.25	29.5	29.75	30.25
Over 400,000	32.25	32.5	32.75	33	33.25	33.75

* Each recipient in Categories I through VI is entitled to a tax rebate equal to 20% of the tax liability resulting from application of the above rates.

(g) Avoidance of double taxation

Panama does not have any unilateral measures for the avoidance of international double taxation; however, such taxation is avoided by the Panamanian system as only Panamanian-situs property is subject to this tax. Internal double taxation is mitigated where the same property is transferred by death more than once during a period not exceeding 10 years. In such a case, the tax due is reduced by 10% per year for the number of years less than 10 for which the property has been held (i.e. by 90%, 80%, 70%, 60%, 50%, 40%, 30%, 20% or 10% where the second transfer at death occurs within 1, 2, 3, 4, 5, 6, 7, 8 or 9 years after the previous transfer at death).

PARAGUAY

(a) General description

The Paraguayan inheritance and gift tax (Impuesto a las Herencias, Legados y Donaciones) is levied on the recipient(s) on the total estate or gift, in accordance with Decree-Law 68 of 6 March 1953 as amended, principally, by Law 1,006 of 19 January 1965. The Paraguayan inheritance system is a mixture of an estate tax and an inheritance tax.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of its apportionment to the recipient(s). Accordingly, taxable property includes Paraguayan-situs property only of a deceased or donor, regardless of the nationality or residence of the transferor and recipient(s).

(c) Exempt property

Exempt property includes, inter alia:
- bequests and gifts to the benefit of the Paraguayan State, public bodies, entities of public interest, charities, social welfare and cultural institutions;
- shares (i.e. equity capital in corporations and partnerships limited by shares);
- State bonds and other qualifying public securities covered by special legislation; and
- bequests and gifts not exceeding 10,000 guaranies (₲) to the benefit of disabled war veterans whose personal net wealth does not exceed ₲20,000.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, real property is assessed at the "cadastral" value; securities (except shares and qualifying public bonds which are exempt) are assessed at face value; live-stock, in accordance with fixed prices established by the Ministries of Finance and Agriculture; and other property items, at market prices. Special rules apply for determining the value of a usufruct and life annuities.

In establishing the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:
- the marriage portion of the surviving spouse; and
- deceased's debts duly substantiated by legal document which are outstanding at the time of death (including taxes, but excluding funeral and related expenses and administration costs).

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest and the donee(s) of a gift) of taxable property is (are) liable for payment of the tax.

However, in calculating the tax due by each recipient, the total value of the estate or gift in question is taken into account. Thus the progression of the tax is first assessed on the gross amount of the estate (or gift) apportioned according to the pertinent group category of recipients and the resulting (average) rate is then levied on each recipient's taxable base. This taxable base is equal to the gross value of the portion received by each recipient less the appropriate deduction. Accordingly, in determining the taxable base of persons included in Category I, each recipient of a transfer at death may deduct, as an allowance, the first ₲100,000 and each donee of an inter vivos gift of movables may deduct the first ₲10,000, regardless of his/her relationship with the donor.

(f) Tax rates

The final inheritance and gift tax is levied on the recipient(s) at the (average) rate resulting from the progression indicated below. The progression takes into account the total value of the estate (or gift) attributable to each category of recipients according to the relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	spouse; direct descendents/ascendents;
II	brothers/sisters;
III	any other (including the Paraguayan Catholic Church).

Taxable base (in ₲)	*I (%)*	*II (%)*	*III (%)*
First 100,000	0	6	10
Next 100,000	5	8	13
Next 200,000	6	10	16
Next 100,000	7	12	20
Next 500,000	9	15	24
Next 1,000,000	11	18	28
Next 2,000,000	13	21	32
Over 4,000,000	15	25	36

Advance levy on the final tax: notwithstanding the final gift tax calculated as above, the donee of a gift inter vivos (including an advance of a portion to a forced heir) is subject to an advance levy which is charged at the progressive rates indicated below on the real value of the property received, where the value of the total estate cannot be established. This levy also takes into account the donee's relationship with the donor and is creditable against the recipient's final inheritance or gift tax.

Real value of gift (in ₲)	*I (%)*	*II (%)*	*III (%)*
First 100,000	4	6	10
Next 100,000	5	8	12
Next 300,000	8	10	15
Over 500,000	10	12	20

In addition to the inheritance or gift tax applicable to Categories I through III (and including the final levy on the final tax), the following cumulative surcharges are imposed on the recipient's advance levy and final tax liability:

- a 25% surcharge where a recipient of a transfer at death has been a non-resident of Paraguay (regardless of his/her nationality) for a period of up to 6 months before the deceased's death, except in duly justified cases; and
- a 50% surcharge where the recipient of a bequest or mortis causa gift is a religious body other than the Paraguayan Catholic Church.

(g) Avoidance of double taxation

Paraguay does not have any unilateral measures for the avoidance of international double taxation. However, such taxation is avoided by the Paraguayan system, pursuant to which only gratuitous transfers of Paraguayan-situs property and rights thereon are subject to tax. Internal double taxation is mitigated where the same assets acquired by inheritance, bequest or mortis causa gift are again transferred at death within a 5-year period and where the tax was paid on the first transfer. In such a case, the tax liability on the second transfer is reduced by 50%, 40%, 30%, 20% or 10%, depending on whether the second transfer occurs within 1, 2, 3, 4 or 5 years, respectively.

PERU

In Peru, there is no inheritance (estate) or gift tax levied either at national or local level. The former inheritance and gift tax (Impuestos Sucesorios) was abolished by Decree-Law 22,719 of 9 October 1979 which introduced, however, a substitute local tax system for certain inter vivos gifts of Peruvian-situs real property. Under this system, as amended by Decree-Laws 298 of 26 July 1984 and 303 of 3 August 1984:

(i) inheritances, bequests, and mortis causa gifts are not subject to any tax in Peru;
(ii) inter vivos gifts (i.e. gifts as an advancement of inheritance) to a donee who is to become at donor's death a forced heir or legatee of the deceased in question are not subject to any tax in Peru; and
(iii) inter vivos gifts other than those indicated in (ii) above are subject to a substitute gift tax (alcabala) where the gift in question consists of real property. In such a case, the donee is subject to a 3% property transfer tax (alcabala) which must be paid to the municipality where such real property is situated.

Exceptionally, gifts (and transfers for consideration) of vessels and aircraft (which are considered under the Peruvian Law as real property) and of rights "in rem" (e.g. usufruct, annuities) by public deed are not subject to "alcabala" tax.

PUERTO RICO (COMMONWEALTH OF)

(a) General description

The Puerto Rican estate and gift duties (Contribuciones sobre Caudales Relictos y Donaciones) are levied on the deceased's estate as a whole or donor's gifts without taking into account the recipient(s) relationship with the deceased or donor, in accordance with Law 167 of 30 June 1968, as amended, principally, by Laws 1/1982 and 8/1983. The Puerto Rican system quite closely follows the pattern of the U.S. federal estate and gift taxes, as contained in the Internal Revenue Code of 1954, as amended.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or donor's gift for purposes of the estate or gift tax. Accordingly, taxable property includes:

(i) any Puerto Rican-situs property of a deceased or donor, regardless of the nationality or residence of the transferor;
(ii) any foreign-situs property of a donor resident of Puerto Rico (regardless of his/her nationality) or of a deceased non-U.S. citizen resident of Puerto Rico;
(iii) any foreign-situs property of a deceased U.S. citizen resident of Puerto Rico who is not subject to the U.S. federal estate tax on his/her world-wide estate; and
(iv) only Puerto Rican-situs property of a deceased U.S. citizen resident in Puerto Rico who would ordinarily be subject to the U.S. federal estate tax on his/her world-wide estate, if he had been a resident elsewhere.

(c) Exempt property

None.

(d) Valuation and deductions

To calculate the net value of the deceased's estate or donor's gift for purposes of the estate or gift tax, the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed at current market prices. Special rules apply for determining the value of a usufruct and life annuities.

In establishing the value of a deceased's taxable estate or donor's taxable gift, the following deductions may be taken:

- deceased's debts (including last illness expenses, mortgages, liens and Puerto Rican taxes) which are outstanding at the time of death and are duly substantiated;
- the first US$4,000 on deceased's funeral expenses duly substantiated;
- casualty losses not covered by insurance or otherwise, where they occur within a 9-month period after deceased's death;
- the marriage portion of the surviving spouse;
- the amount of bequests and inter vivos gifts to the benefit of the U.S. or Puerto Rican governments and for public, charitable or religious purposes;
- 50% of the value on deceased's qualifying investments (i.e. in activities of socio-economic interest and savings bonds from the Commonwealth of Puerto Rico) maintained for at least 3 years; or, as an alternative deduction, the first US$200,000 on the value of such investments. This US$200,000 deduction may also be taken by a donor who made such an inter vivos gift as of 1 January 1983, where the gift consists of qualifying investments;
- 100% of the value of agropastoral undertakings from which the deceased derived more than 50% of his/her net income during the 3-year period before death. To qualify for this deduction, it is required that such undertakings remain productive for at least a 10-year period after deceased's death;
- the first US$10,000 on deceased's life insurance policy received by the administrator or by the surviving spouse or heirs;
- the first US$10,000 on the balance of deceased's savings deposits and death benefits; and
- a portion of the fees paid to attorneys or professional practitioners, calculated as a percentage of the gross estate in question or as a lump sum if this amount is greater (e.g. 3% for up to US$100,000; 2.5% or US$3,000 for up to US$500,000; 2% or US$15,000 for up to US$1,000,000; and 1.5% or US$20,000 for a gross estate exceeding US$1,000,000).

(e) Taxable persons and taxable base

In the case of the estate tax, the administrator/executor alone (or exceptionally jointly with the deceased's heirs where he/she has been released from sole responsibility by the Puerto Rican Secretary of Finance) is liable for the tax; and, in the case of the gift tax, the donor alone (or jointly with the donee(s) where it becomes necessary) is liable for the tax.

Both estate and gift tax is charged, respectively, on the estate's or gift's taxable base. The taxable base of a deceased or donor resident of Puerto Rico is equal to the taxable estate (i.e. gross estate less pertinent deductions) or gift (i.e. aggregate of gross gifts during a calendar year less pertinent deductions), without any further deductions.[14]

The taxable base of non-residents is established as follows:

- in the case of a deceased non-U.S. citizen, the taxable base is equal to the taxable estate in question as reduced by US$10,000 allowance;
- in the case of a deceased U.S. citizen, the taxable base is equal to the taxable estate as reduced by an allowance which amounts to the greater of either US$30,000 or the portion of US$60,000 that the value of the Puerto Rican-situs property bears to the value of the world-wide gross estate;
- in the case of inter vivos gifts, the donor's taxable base is equal to the taxable gift during a calendar year reduced by US$10,000 for each year and each donee (US$11,000 for each year where the donee is a donor's permanently handicapped child).

(f) Tax rates

As a general rule, both estate and gift tax are charged at the progressive rates indicated below. The progression

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[14] The former allowances of US$60,000 for a resident deceased's taxable estate and US$30,000 for a resident donor's life time gifts have been abolished.

takes into account only the deceased's or donor's taxable base.

Taxable base of estate or gift (in US$)	*Estate/gift tax rate*(%)*
First 10,000	18
Next 10,000	20
Next 20,000	22
Next 20,000	24
Next 20,000	26
Next 20,000	28
Next 50,000	30
Next 100,000	32
Next 250,000	34
Next 250,000	37
Next 250,000	39
Next 250,000	41
Next 250,000	43
Next 500,000	45
Next 500,000	49
Over 2,500,000	50

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* However, a maximum sum of US$121,800 may be credited against and up to the amount of the estate tax, resulting from application of the above rates, charged on the taxable base of a resident deceased; in the case of the gift tax charged on the taxable base of a resident donor, the available tax credit is equal to maximum US$121,800 less the amounts of foreign tax credit (see below) and of credits for gift tax paid by that donor in the year in question and any preceding years.

(g) Avoidance of double taxation

Puerto Rico has adopted the credit method, as a unilateral measure for avoidance of international double taxation on estates and gifts of a resident deceased or donor; accordingly, the foreign estate/inheritance or gift tax effectively paid on foreign-situs property may be credited against and up to the amount of the Puerto Rican estate or gift tax attributable to such property.

Internal double taxation is also mitigated where more than one transfer at death or inter vivos gift occurred within a 10-year period before the current death transfer. In such a case the tax due on the current transfer which is attributable to property previously taxed is reduced by 100%, 80%, 60%, 40% or 20%, depending on whether the previous transfer occurs within 2, 4, 6, 8 or 10 years before the current death transfer.

SURINAM

(a) General description

The Surinam inheritance and (mortis causa) transfer tax (Successie- en Overgangsbelasting) is levied at different rates on the recipient(s), in accordance with Ordinance of 1 June 1830 as amended, principally, by Ordinance of 14 May 1934. Gifts inter vivos are not subject to any tax.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or in the mortis causa transfer in question for purposes of its apportionment to the recipient(s). Accordingly, taxable property includes:

(i) any Surinam and foreign-situs property of a deceased resident of Surinam, regardless of the nationality or residence of transferor and recipient(s) (i.e. inheritance tax); and

(ii) only Surinam-situs real property of a deceased non-resident of Surinam, regardless of the nationality or residence of transferor and recipient(s) (i.e. transfer tax).

(c) Exempt property

In the case of the inheritance tax, exempt property includes:

- an amount not exceeding 300 Surinam guilders (US$1 = Sfl1.8);
- inheritances or bequests to the benefit of recipients in Category I (see below); and
- inter vivos gifts, regardless of the recipient's category.

In the case of the transfer tax, exempt property includes:

- any Surinam-situs property which does not consist of real property or rights thereon transferred at death; and
- any foreign-situs property.

(d) Valuation and deductions

To calculate the value of the estate apportionable to the recipient(s), the value of the taxable property in question must be assessed. For this purpose, the property in general is assessed at current market prices.

In the case of the inheritance tax, to establish the amount of estate apportionable to the recipient(s), the following liabilities may be deducted:

- deceased's personal and business debts outstanding at the time of death and duly substantiated;
- Surinam taxes owed by the deceased at the time of death; and
- last illness and funeral expenses.

In the case of the transfer tax, the net value of the Surinam-situs property is established without deducting any of the above liabilities.

(e) Taxable persons and taxable base

For purposes of the inheritance tax, taxable persons are the recipients (other than those included in Category I) of an inheritance, bequest or mortis causa gift. In the case of the transfer tax, taxable persons are the recipients of Surinam-situs real property or rights thereon.

Both inheritance and transfer tax is charged on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of estate apportioned to the pertinent recipient, without any deductions.

There are no anti-avoidance measures related to gifts inter vivos, because such gifts are not subject to any tax (including income tax).

(f) Tax rates

Each recipient (other than those in Category I) is subject to the inheritance tax at the flat rates indicated below, regardless of his/her nationality or residence. This tax takes into account only the recipient's relationship with the deceased and whether such a recipient acquires the full ownership or only the usufruct of the apportioned property. The tax is charged at half rates to the beneficiary of a usufruct.

The transfer tax is levied at 8% on recipients other than usufructuaries and at 4% on the beneficiary of an usufruct.

For purposes of the inheritance tax, the following categories of recipients are distinguished, according to the wording of the law:

Category	*Recipient's relationship*
I	direct descendent/ascendent; surviving spouse with one or more married children or direct descendents of these children;
II	surviving spouse without married children or direct descendents;
III	brother/sister;
IV	nephew/niece; uncle/aunt; first cousin;
V	any other person (including illegitimate children).

I *(%)*	*II* *(%)*	*III** *(%)*	*IV** *(%)*	*V* *(%)*
0	6	6	9	15

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* In addition to these basic rates applicable to persons included in Categories III and IV, each of these recipients is eventually subject to a 15% excess tax. The excess tax applies where the deceased's will apportions to such a collateral recipient an amount which exceeds in value the legal portion that such a recipient would have inherited if the deceased had died intestate and without next of kin (i.e. no Category I or II recipients); in that case, the tax is levied at 6% or 9% (halved for usufructuaries), respectively, on the portion which he/she would have inherited ab intestato plus 15% (halved for usufructuaries) on the excess over such a portion.

(g) Avoidance of double taxation

Surinam does not have any unilateral measures for the avoidance of international or internal double taxation of inheritances or gifts.

URUGUAY

In Uruguay, there is no inheritance (estate) or gift tax levied either at national or local level. The former inheritance and gift tax (Impuesto a las Herencias y Actos Asimilados) and substitute inheritance tax (Impuesto Sustitutivo del de Herencias) were abolished by Law 14,252 of 22 August 1974.

Accordingly, gratuitous transfers of property and rights thereon are not subject to any tax in Uruguay.

VENEZUELA

(a) General description

The Venezuelan inheritance and gift tax (Impuesto sobre Sucesiones, Donaciones y demás Ramos Conexos) is levied on the recipient(s), in accordance with the Law of 13 August 1982, effective on 20 September 1984.

(b) Taxable property

Taxable property means property includable in the deceased's gross estate or the gift in question for purposes of tax apportionment to the recipient(s). Accordingly, taxable property includes:

(i) Venezuelan-situs property of a deceased or donor, regardless of the nationality or residence of transferor and recipient(s); and

(ii) Venezuelan-"presumed-situs" movable property, consisting of:
  - either Venezuelan-"source" securities (regardless of the nationality or residence of the deceased/donor or recipient) and foreign-"source" securities of a deceased or donor who is a resident of Venezuela,
  - or Venezuelan-"source" personal rights and debt-claims (i.e. arising from contracts executed in Venezuela), regardless of the nationality or residence of the deceased/donor or recipient.

(c) Exempt property

Exempt property includes, inter alia:

- bequests and gifts to the benefit of the Venezuelan State, public bodies, welfare institutions and entities of public interest;
- the homestead, consisting of the deceased's habitual residence (including household furnishings and personal belongings, but excluding jewelry and art objects), regardless of its value, to be used as habitual residence by the deceased's next of kin;
- death benefits and compensation on deceased's life insurance;
- gifts not exceeding 25,000 bolivares (Bs.) to each donee during a 5-year period;
- gifts consisting of mandatory pensions or alimonies to a donor's spouse, a descendent or an ascendent;
- gifts consisting of a maximum sum of 250,000 Bs. deposited for the benefit of each donor's minor child in savings accounts with local banking institutions; and
- gifts consisting of a maximum sum of 375,000 Bs. received by each donor's minor child as premiums and lump sums on account of donor's endowment toward a daughter's marriage or for savings accounts for donor's children.

(d) Valuation and deductions

To calculate the value of the estate or gift apportionable to the recipient(s), the value of the taxable property in question must be officially assessed. For this purpose, the property in general is assessed at market prices.

Special rules apply for determining the value of a usufruct and life annuties.

In establishing the taxable amount of the estate apportionable to the recipient(s), the following liabilities may be deducted:

- any debts owed by the deceased (other than those affecting his/her habitual residence), including taxes, which are outstanding at the time of death and are duly substantiated;
- death, funeral and related expenses; and
- an amount of fees paid to attorneys or similar professional practitioners involved with the inheritance procedure, calculated on the value of the apportionable estate in question (i.e. 0% for up to 20,000 Bs.; 6% for up to 50,000 Bs.; 4% for up to 200,000 Bs.; 3% for up to 500,000 Bs.; and 2% for the excess.

(e) Taxable persons and taxable base

The recipient(s) (i.e. the heir(s) or legatee(s) of an inheritance or bequest) and the donee(s) jointly with the donor of taxable property is (are) liable to tax. The inheritance or gift tax is levied on each recipient's taxable base (i.e. on the amount effectively received). This taxable base is equal to the gross amount of the estate (or gift) apportioned to the pertinent recipient, without any deductions.

However, as an anti-avoidance measure, gifts made in donor's lifetime to the same donee (including a donor's future heir or legatee) within any 5-year period or before donor's death, must be added together for the purpose of determining the beneficiary's taxable base.

(f) Tax rates

The inheritance and gift tax is levied at the progressive rates indicated below. These take into account the recipient's taxable base and his/her relationship with the deceased or donor. For this purpose, the following categories of recipients are distinguished:

Category	*Recipient's relationship*
I	spouse; direct ascendent/descendent (including an adopted child);
II	brother/sister; nephew/niece;
III	uncle/aunt; first cousin;
IV	any other person.

Taxable base (in Bs.)	*I (%)*	*II (%)*	*III (%)*	*IV (%)*
First 15,000	1	2.5	6	10
Next 35,000	2.5	5	12.5	15
Next 50,000	5	10	20	25
Next 150,000	7.5	15	25	30
Next 250,000	10	20	30	35
Next 500,000	15	25	35	40
Next 3,000,000	20	30	40	45
Over 4,000,000	25	40	50	55

However, the tax liability resulting from application of the above rates may be reduced by one of the following rebates available to qualifying recipients of an inheritance, bequest or gift. The rebate, which may not exceed 100,000 Bs. for each recipient, can only be taken where the sum of both his/her taxable base and net wealth added together does not exceed 500,000 Bs. A recipient may elect only one rebate, even if he or she falls into more than one category.

	If the recipient's net wealth + taxable base is:	
Qualifying recipient	*maximum 500,000 Bs. (tax rebate in %)*	*maximum 250,000 Bs. (tax rebate in %)*
spouse; child under 21	20	40
a person over 60; a totally and permanently handicapped person	15	30
a permanently but only partially handicapped person	12.5	25
an heir/legatee with dependent children (for each wedded/natural/adoptive child	2.5	5

(g) Avoidance of double taxation

Venezuela does not have any unilateral measures for the avoidance of international double taxation. However, such taxation is avoided in most cases, pursuant to the rule that only transfers of Venezuelan-situs (or "presumed-situs") property are subject to tax. Internal double taxation is mitigated where the same property is transferred at death more than once to a direct descendent/ascendent within a 5-year period. In such a case, the current tax on such property is reduced by 50%, 40%, 30%, 20% or 10%, depending on whether the time-span between the two transfers is 1, 2, 3, 4 or 5 years respectively. As for gifts inter vivos received by a donor's forced heir or legatee during a 5-year period before donor's death, the gift tax on such property is creditable against the heir or legatee inheritance tax.

CONCLUSION

As is readily noted from this survey, we have used a practical approach; a "funnel system" which narrows the target, i.e. the taxable amount due by each recipient, by firstly, describing the method of taxation; secondly, listing the exemptions, then the deductions until, finally, arriving at the taxable base and taxable recipients. Through this method, the reader can quickly determine the taxable amount to be paid by each recipient in each of the countries surveyed.

Tax Effort and Measures of Fiscal Stabilization Performance

By Charles Y. Mansfield

In the last decade increased expenditure demands, often locked in by legislative and legal requirements, have combined with lagging revenues to produce increasing fiscal deficits. The phenomenon of widening deficits has been virtually worldwide, applying to both industrial and developing countries. The dimensions of the problem in terms of taxation are shown in Table 1, which presents fiscal deficits as a percentage of government revenue. This table indicates the increase in taxation that would be necessary to reduce fiscal deficits to viable amounts. Without such action a common problem presented to international organizations and national authorities is to evaluate an economy's fiscal performance from a stabilization point of view. This evaluation involves answering questions such as: Does a taxation or "fiscal problem" exist and, if so, to what degree? How should the "fiscal problem" be identified and measured? Is the fiscal stabilization policy being pursued by the government successful or unsuccessful? Attempts to answer these questions, particularly when comparing countries with each other, generally involve the use of simple ratios, or what may be called "proxy measures" of performance. This paper aims at clarifying the issues involved in evaluating fiscal and taxation performance by the use of simple proxies. The paper reviews existing proxy measures, tests their empirical effectiveness, and suggests limitations in their application. Given the international setting, the emphasis is on the balance of payments goals of stabilization.

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1. What do we mean by "proxy measures" and why use them?

Proxy measures represent an attempt to judge the performance of the fiscal sector by using one or a few simple numbers or ratios rather than spelling out in detail a more complete model showing the relationships between fiscal variables and the rest of the economy. For example, the size of the overall fiscal deficit, either in absolute terms or relative to gross domestic product (GPD), is often taken as an initial measure of the extent of a fiscal stabilization "problem". It would be tempting to contrast simple fiscal ratios with more complete models of the economy, but a fundamental point in assessing fiscal ratios is that they themselves represent short-cut implied models, and can only be as accurate as the implied models underlying them. In practice, simple measures of fiscal performance have been found to be useful and ultimately necessary, since more elaborate models may not be feasible because of data or time limitations, In addition, simple measures have gained greater respectability as more elaborate models have not necessarily proved to be more "correct" in explaining or predicting fiscal performance.[1]

2. Objectives of fiscal stabilization measures

Before discussing specific measures of fiscal stabilization, it would be well to consider the questions the indicators are meant to answer. A list of questions pertinent

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[1] In analyzing fiscal policy in the United States, for example, Chand defends the use of a simple impulse indicator by noting that "a simple indicator can contribute to analysis by indicating broad outlines that might otherwise be obscured by excessive concern with structural details." Sheetal K. Chand, "Can Fiscal Policy be Stabilizing? An Assessment Based on U.S. Data," International Monetary Fund, DM/83/42 (June 1983).

to judging fiscal stabilization or tax effort indicators would include:

a. Is the government contributing to excess demand for goods and services which will lead to an unsustainable current account or overall balance of payments deficit?
b. Does the financing of the budget involve the creation of excess liquidity, again leading to pressure on the balance of payments, domestic inflation, or both?
c. Is the public sector absorbing a disproportionate share of the pool of savings available, thereby leading to a stabilization problem as private investment competes for limited voluntary savings?

In what follows below, proxy measures of fiscal and taxation performance designed to answer these questions will be discussed. At the outset a fundamental distinction should be made between "actual" measures, that is, measures employing actual outcomes, and normative or implicit measures which aim at separating the effect of "fiscal policy" actions from other forces operating on the budget. Normative measures, as treated below, raise fundamental objections to the correctness of actual measures, but open difficulties of their own in terms of measurement and utility for policy purposes.

3. The wide variation in government deficits: empirical evidence

The overall central government deficit, taken as an absolute value or as a ratio to GDP, is the most widely used single number or ratio by which fiscal stabilization performance is judged. Another simple measure is the ratio of the overall deficit to tax revenues. Yet these measures alone offer at best an inadequate guide to our initial question: whether a "fiscal problem" from the stabilization point of view exists in a country. As a starting point, one can examine the wide range of fiscal deficits actually found, and later ask whether these deficits represent a legitimate ranking of the extent of a fiscal stabilization problem. Tables 1 and 2 show the range of fiscal deficits to GNP, as well as the fiscal deficit as a percentage of revenue for industrialized and development countries, respectively. (The revenue measure indicates how much tax receipts would have to be increased to attain a balanced budget.) A glance at either table shows how widely these measures of fiscal performance can differ. The mean central government deficit ratio for industrialized countries is –5.4% of GDP, or –21.5% of revenue; the range of the GNP ratio varies from –0.3 for Switzerland to –16.3 for Ireland. Developing countries show even wider variability. Among oil exporting countries the surplus of Kuwait, amounting to 38.5% of GDP, can be regarded as a special case. Other oil exporting countries have deficits, ranging to –9.6% of GDP and –37.8% of revenue for Iran. Considering other geographical regions, 26 countries of Africa have a mean deficit of –5.7% of GDP and –31.9% of revenue, with a range for the GDP ratio of –16.5% for Zambia to –0.5% for the Seychelles. For 12 countries of Asia the mean is –5.4% of GDP and –31.4% of revenue. Twenty-five countries of the Western Hemisphere had a mean deficit of –4.7% of GDP and –29.2% of revenue, with the GDP ratio ranging from –17.5% in Jamaica to a surplus of 0.4% in Suriname. (Data represent a three-year average for the latest years available.)

Table 1
Ratio of overall fiscal deficit to GNP for industrial countries
(Three-year average for latest years available)

			Overall fiscal deficit as percent of	
			Revenue	*GNP*
United States	1981	1983	–21.4	–4.2
Canada	1981	1983	–26.8	–5.4
Australia	1981	1983	–7.6	–2.0
Japan	1977	1979	–84.7	–6.1
New Zealand	1979	1981	–18.4	–5.9
Austria	1980	1982	–16.2	–3.4
Belgium	1981	1983	–45.4	–13.6
Denmark	1980	1982	–16.2	–5.9
Finland	1980	1982	–7.7	–1.9
France	1978	1980	–5.1	–0.3
Germany	1981	1983	–16.2	–2.3
Iceland	1980	1982	–5.4	–1.8
Ireland	1980	1982	–38.2	–16.3
Italy	1981	1983	–35.3	–11.3
Netherlands	1981	1983	–20.6	–7.1
Norway	1979	1981	–5.3	–2.1
Spain	1979	1981	–20.2	–5.0
Sweden	1980	1982	–24.2	–9.0
Switzerland	1981	1983	–4.2	–0.3
United Kingdom	1981	1983	–10.5	–3.9

Source: *International Financial Statistics..*

While the range of fiscal deficits is a matter of fact, we want to examine the question of whether the fiscal deficit ratio to GNP or GDP is an accurate predictor of the extent of a fiscal stabilization "problem". This latter question has been pursued in several directions. First, the overall fiscal deficit has been related to the balance of payments (BOP) current account deficit, following the argument that a larger government deficit increases domestic absorption, and (other things being equal) should lead to pressure on the external account. An analogous connection has been drawn using monetary links between the fiscal sector and the BOP. These two linkages assume that in fact the overall deficit and its monetary counterpart do represent an accurate index of excess demand for goods and services. This assumption is dropped in following another line of analysis which relates the overall deficit to the total pool of savings in the economy. These ideas are explored in turn below.

4. Overall fiscal deficit related to balance of payments

In making some meaning of the wide range of overall fiscal deficits to GNP or GDP found empirically, a number of attempts have been made to relate the fiscal

Table 2
Ratio of overall fiscal deficit to GDP for developing countries
(Three-year average for latest years available)

			Overall fiscal deficit as percent of	
			Revenue	GDP
Oil exporting				
Algeria	1972	1974	−10.0	−3.0
Indonesia	1980	1982	−9.0	−2.1
Iran, Islamic Rep. of	1979	1981	−37.8	−9.6
Kuwait	1980	1982	42.2	38.5
Nigeria	1976	1978	−12.0	−3.2
Oman	1980	1982	−5.6	−2.1
Venezuela	1980	1982	−11.2	−3.3
Africa				
Botswana	1980	1982	−8.8	−3.4
Burundi	1980	1982	−11.8	−1.6
Cameroon	1980	1982	−9.9	−1.9
Chad	1974	1976	−17.4	−1.8
Ethiopia	1977	1979	−25.7	−4.1
Gabon	1974	1976	−41.0	−11.4
Gambia, The	1976	1978	−32.9	−6.6
Ghana	1979	1981	−102.6	−5.6
Kenya	1981	1983	−22.6	−5.0
Liberia	1980	1982	−47.8	−12.9
Madagascar	1972	1974	−14.3	−2.4
Malawi	1981	1983	−42.6	−7.6
Mauritius	1978	1980	−57.5	−11.5
Morocco	1979	1981	−43.7	−11.3
Niger	1978	1980	−26.0	−3.7
Rwanda	1978	1980	−13.5	−1.7
Seychelles	1976	1978	−1.9	−0.5
Sierra Leone	1979	1981	−72.3	−10.5
South Africa	1981	1983	−16.5	−3.4
Sudan	1978	1980	−29.0	−4.1
Swaziland	1980	1982	−6.6	−1.1
Tanzania	1977	1979	−35.1	−6.7
Tunisia	1979	1981	−10.6	−3.4
Uganda	1970	1972	−52.0	−6.6
Zaire	1979	1981	−20.2	−3.9
Zambia	1980	1982	−67.8	−16.5
Asia				
Burma	1980	1982	7.3	1.2
Fiji	1979	1981	−14.0	−3.2
India	1980	1982	−67.1	−6.7
Korea	1980	1982	−15.8	−2.9
Malaysia	1981	1983	−61.4	−17.0
Nepal	1979	1981	−34.2	−2.8
Pakistan	1980	1982	−33.7	−5.4
Papua New Guinea	1979	1981	−20.7	−4.2
Philippines	1981	1983	−28.7	−3.3
Singapore	1979	1981	9.4	1.2
Sri Lanka	1980	1982	−95.0	−18.4
Thailand	1981	1983	−23.5	−3.4
Europe				
Cyprus	1980	1982	−29.6	−6.5
Greece	1980	1982	−29.6	−6.2
Hungary	1981	1983	−1.9	−1.1
Malta	1978	1980	37.5	1.8
Portugal	1974	1976	−44.7	−6.6
Turkey	1979	1981	−17.5	−3.9
Yugoslavia	1979	1981	−4.7	−0.8
Middle East				
Bahrain	1980	1982	15.7	4.5
Israel	1978	1980	−28.6	−15.3
Jordan	1981	1983	−31.3	−8.2
Yemen Arab Republic	1979	1981	−70.9	−16.7
People's Democratic Republic of Yemen	1978	1980	−28.0	−0.4
Western Hemisphere				
Argentina	1979	1981	−28.1	−4.8
Bahamas	1978	1980	−16.9	−1.7
Barbados	1979	1981	−14.5	−4.0
Belize	1978	1980	−6.7	−1.6
Bolivia	1980	1982	−82.5	−7.6
Costa Rica	1979	1981	−31.6	−5.7
Dominica	1977	1979	−10.9	−3.1
Dominican Republic	1979	1981	−26.9	−3.7
Ecuador	1980	1982	−32.2	−3.6
El Salvador	1980	1982	−44.3	−5.9
Grenada	1975	1977	−18.4	−4.0
Guatamala	1981	1983	−56.6	−4.9
Guyana	1971	1973	−54.8	−13.3
Haiti	1981	1983	−39.4	−4.5
Honduras	1981	1983	−39.1	−5.3
Jamaica	1978	1980	−70.8	−17.5
Mexico	1979	1981	−29.0	−4.4
Nicaragua	1978	1980	−51.8	−7.2
Panama	1980	1982	−21.6	−6.4
Paraguay	1979	1981	−1.1	−0.1
Peru	1980	1982	−20.9	−3.9
St. Lucia	1980	1982	−11.7	−3.6
Suriname	1980	1982	−8.5	0.4
Trinidad and Tobago	1979	1981	7.7	3.3
Uruguay	1980	1982	−19.0	−4.1

Source: *International Financial Statistics.*

deficit to the current account deficit of the BOP.[2] This relationship is the first of a series of implied models. It has the advantage of a clear basis in national account identities as well as a substantive theory in the form of the "fiscal approach to the balance of payments".

Beginning with the identity that the current account of the BOP is equal to the gap between national savings and investment, we have:

$Z - X = I - S$[3] (1)

Separating the goverment from the rest of the economy,

$Z - X = (I_p - S_p) + (I_g - S_g)$[4] (2)

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[2] An interesting formulation relating to developing countries is found in Elizabeth A. Milne, "The Fiscal Approach to the Balance of Payments", *Economic Notes*, Monte dei Paschi di Siena, Vol. 6, No. 1 (1977), pp. 89-106.

[3] Where Z = imports of goods and services; X = exports of goods and services; I = investment; and S = national savings.

[4] Where $I_p - S_p$ = private sector surplus or deficit; and $I_g - S_g$ = overall government surplus or deficit.

Equation (2) can be taken to imply that a change in the overall fiscal deficit ($I_g - S_g$) would change the external current account balance if other conditions, in particular the private sector balance, remain constant.[5] The apparent simplicity of this formulation is deceptive, however, as the relationship between the overall fiscal deficit and current account BOP deficit is in fact tangled and far from straightforward. In investigating the fiscal-BOP connection, it is perhaps most convenient to begin by testing the simplest formulation, and then raising successive objections to it.

Table 3 shows the result of testing regression equations based on the fiscal approach to the BOP. The first three regressions relate the level of the fiscal deficit, in simultaneous and lagged form, and changes in the fiscal deficit, to the corresponding versions of the current account BOP deficit. Annual data were used, ranging in most cases from 1965 to latest available year.[6]

$$\frac{X-Z}{\text{GNP or GDP}} = a+b\,\frac{T-G}{\text{GNP or GDP}} \tag{3}$$

$$\frac{X-Z_t}{\text{GNP or GDP}_t} = a+b\,\frac{(T-G)_{t-1}}{\text{GNP or GDP}_{t-1}} \tag{4}$$

$$\frac{\Delta\,(X-Z)}{\text{GNP or GDP}} = a+b\,\frac{\Delta\,(T-G)}{\text{GNP or GDP}} \tag{5}$$

Table 3
Significant links between overall fiscal deficits and current account balance of payments deficits[a]

	Level of current account BOP deficit related to overall fiscal deficit	*Change in current account BOP related to change in overall fiscal deficit*	*Current account BOP deficit related to previous year overall fiscal deficit*	*Current account BOP deficit related to overall fiscal deficit and inflation*
Industrial countries	4 of 17	1 of 17	4 of 17	4 of 18
Developing countries	25 of 56	12 of 54	16 of 56	18 of 55
Oil exporting	3 of 4	2 of 4	1 of 4	3 of 5
Africa	9 of 16	3 of 16	5 of 16	5 of 16
Asia	3 of 9	3 of 9	4 of 9	3 of 9
Europe	1 of 4	0 of 4	1 of 4	1 of 4
Middle East	3 of 3	0 of 3	2 of 3	1 of 3
Western Hemisphere	6 of 20	4 of 18	3 of 20	5 of 18

Source: *International Financial Statistics.* Countries in sample were correlated with *Government Finance Statistics* data at 95% level of significance or above for T ratio.

a. Significant links defined as T ratio significant at 95% level for null hypothesis that B = 0 in the following regressions:

$$\text{(1)}\quad \frac{Z-X}{\text{GNP or GDP}} = a+b\,\frac{(T-G)}{\text{GNP or GDP}}$$

$$\text{(2)}\quad \frac{\Delta\,(Z-X)}{\text{GNP or GDP}} = a+b\,\frac{\Delta\,(T-G)}{\text{GNP or GDP}}$$

$$\text{(3)}\quad \frac{Z_t-X_t}{\text{GNP or GDP}} = a+b\,\frac{(T-G)_{t-1}}{\text{GNP or GDP}}$$

$$\text{(4)}\quad \frac{Z-X}{\text{GNP or GDP}} = a+b\,\frac{(T-G)}{\text{GNP or GDP}} + c\,\frac{\Delta P}{P}$$

(GNP used for industrial countries and GDP for developing countries.)

At first glance, it is somewhat surprising in these simple regressions to find a relatively low number of significant relationships between the fiscal and current account deficits. For industrial countries *levels* of deficits as well as *changes in levels* were significantly related in only a few cases. For developing countries, the number of significant relationships is somewhat greater, amounting to about 45% of the countries tested for *levels*, but less than 25% for *changes* in levels.

Why is the empirical connection between fiscal and BOP current account deficits not closer? Perhaps the most fundamental reasons are two: First of all, the overall fiscal deficit is not in itself necessarily a valid indicator of excess demand stemming from the government sector; and, secondly, a number of influences may be acting on the BOP current account deficit in addition to the fiscal deficit. Leaving these major objections aside for the moment, let us assume that the overall fiscal deficit is a valid indicator of excess demand for goods and services and that no other major influences (e.g, changes in terms of trade or exogenous changes affecting foreign and domestic demand and supply) are acting on the BOP current account. Given these assumptions, we might still expect that the fiscal-BOP connection would not be clear-cut over a period of time. For example, in response to a widening fiscal deficit and deteriorating current account (and/or overall BOP deficit) import restrictions may be imposed. In such circumstances, the BOP current account balance may improve as the fiscal deficit widens. Excess demand would then be reflected in domestic inflation rather than a larger BOP current account deficit. Equations (6) and (7) are designed to test whether the significance of the fiscal deficit is improved by taking account of this diversion of demand.

$$\frac{X-Z}{\text{GNP or GDP}} = a+b\,\frac{T-G}{\text{GNP or GDP}} + c\,\frac{\Delta P}{P} \tag{6}$$

$$\frac{\Delta\,(X-Z)}{\text{GNP or GDP}} = a+b\,\frac{\Delta\,(T-G)}{\text{GNP or GDP}} + c\Delta\,\frac{\Delta P}{P} \tag{7}$$

However, as shown in Table 3, the addition of this variable had little effect on the number of countries with significant links between the fiscal and current account deficits.

Another plausible hypothesis is that an overall fiscal deficit would be highly correlated with a BOP current account deficit when private demand is strong, but not in recessionary conditions when private demand is weak. Following this line of thought countries with significant BOP-fiscal links in the sample were examined to see whether they had less variability in the growth of real GNP, indicating that the fiscal-BOP relationship would be less affected by contrasting boom and recessionary

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[5] See Margaret R. Kelly, "Kelly Adjustment and Fund-Supported Programs, 1971-80", *Staff Papers*, International Monetary Fund, Vol. 29, No. 4 (December 1982) for a full exposition of these fiscal identities and the monetary identities in section 8 below.

[6] The sample consists of countries for which data from *International Financial Statistics* were correlated with data from *Government Finance Statistics* with a T statistic of 95% level of significance or above.

conditions. Again, this test was not conclusive, indicating that while this factor might be important in certain cases, it was not in itself a dominant influence in explaining the presence or absence of a significant fiscal-BOP link.

5. Financing of the overall deficit

As noted above, an important reason for the absence of a more significant fiscal deficit-BOP current account link is that the overall deficit is not necessarily a valid indicator of excess demand. Although a ranking of overall fiscal deficit implicitly assumes that the size of the fiscal deficit represents an index of excess demand leading to pressure on the BOP, critics have pointed out that it is naive to hold that any particular level of fiscal deficit is necessarily a disequilibrium one. Keeping in mind that the sum of savings and dis-savings in all sectors (foreign and domestic) must equal zero, the fiscal deficit could be simply the reflection of voluntary savings in other sectors of the economy.[7]

If business and personal savers voluntarily lend to the government, a higher government deficit could be sustained without expansionary pressures. This approach to the fiscal deficit leads us to examine the size of the fiscal deficit in comparison to total savings in the economy. If savings are large, then a larger fiscal deficit can be accommodated without crowding out private investment and without excess demand leading to pressure on interest rates, prices, and the BOP. A basic identity which is useful here is:

$$\frac{\text{government deficit}}{\text{GNP}} = \frac{\text{government deficit}}{\text{savings}} \times \frac{\text{savings}}{\text{GNP}} \quad (8)$$

This identity points up the fact that if savings are large as a proportion of GNP, a larger "equilibrium" ratio of the government deficit to GNP could be sustained.

While this measure is clear in concept, some difficulties arise in defining the pool of savings that is available to finance private investments and the government deficit. This pool of savings has been defined as gross private savings, consisting mainly of personal (household) saving and gross saving (i.e., retained operating receipts) of business enterprises, but also including the saving (positive or negative) of local and regional governments, as well as statistical discrepancies in official estimates of national expenditures and national income flows.[8] The available pool of savings by this definition covers the entire flow of domestic saving (by sectors other than the central government) that is available to finance (a) private domestic investment, (b) the central government fiscal balance, and (c) any net investment abroad.

A difficulty with this definition of the total pool of savings available revolves around the question of how to treat foreign capital inflows or outflows. For developing countries and certain industrial countries as well net foreign capital inflows may add to the pool of savings available to finance private domestic investment and the government deficit. In such cases "sustainable" capital inflow should be added to domestic savings to obtain an equilibrium pool of savings available to finance private investment and the fiscal deficit. Similarly, a "mature creditor" may use domestic savings to finance a continuing capital outflow.

As suggested by the above identity, the size of an equilibrium fiscal deficit can vary depending on the size of the pool of savings available. This line of analysis has been followed in explaining why some industrialized countries have higher fiscal deficit ratios to GNP, yet lower rates of inflation and interest rates. An often cited example of different equilibrium fiscal deficits is that of Japan and the United States. Japan, with a larger pool of savings, has been able to finance a relatively larger fiscal deficit to GNP without attendant strains on the price level and BOP. Similarly, the United Kingdom borrowing requirement to GNP has been below the figure for Japan but, like the United States, represents a portion of gross savings higher than Japan. This approach also makes more meaningful the case of Italy, where gross private saving to GNP is much higher than in other industrial countries. Although Italy's government deficit to GNP is very high (see Table 1), high savings by the private sector in Italy are used to cover both the exceptionally large deficit of the central government and domestic investment outlays that are not very different, as a percentage of GNP, from those in the Federal Republic of Germany and France.[9]

In summary, the use of the concept of the total pool of savings available to finance the government deficit has helped to make more meaningful the wide range of fiscal deficits to GDP actually observed. A higher overall deficit, if financed by voluntary savings, is not necessarily a valid indicator of excess demand pressing on the BOP. Analysis of this type has been limited mainly to industrial countries. However, an extension of this line of reasoning makes it clear why the fiscal-BOP current account link improves when using a sample of developing countries. In such countries voluntary financing of the overall fiscal deficit tends to be replaced by bank credit and consequent money growth in excess of equilibrium demand for money holdings. As the overall fiscal deficit becomes a better proxy for excess demand we would expect a higher linkage between the overall fiscal deficit and the current account BOP deficit.

An example of a more significant linkage in disequilibrium settings is found in a study by Kelly (1982). This study focused on *changes* in fiscal and BOP deficits and dealt with time periods during which a particular effort at fiscal adjustment (lowering of the overall deficit to GDP) was being made. The sample was a group of highly disequilibrium developing countries (those with upper credit tranche stand-by arrangements with the Fund); and the question asked was whether *changes* in the fiscal deficit to GNP were linked to corresponding *changes* in the current account BOP balance. Of 77 pro-

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[7] This view is forcibly expressed in James Tobin, "Deficit, Deficit, Who's Got the Deficit?," *National Economic Policy* (New Haven: Yale University Press, 1966).

[8] See International Monetary Fund, *World Economic Outlook* (1982).

[9] See International Monetary Fund, *World Economic Outlook* (1983), p. 113.

gram periods covered in the analysis, 48 programs showed the fiscal deficit and BOP current account moving in the same direction, while 29 did not. Using a regression approach, the *change* in the BOP current account was regressed on the *change* in the overall deficit, using cross-sectional data. The coefficient B was found to be significant when all 77 programs were analyzed, although the overall explanatory power of the equation (R^2) was low.[10] Another analysis of the link between the fiscal and current account balances in the context of adjustment from disequilibrium was reported in the *World Economic Outlook* (1983). Taking the period of the second oil shock (1978-82) and using a sample of 82 non-oil developing countries, a relationship was found between the *change* in the fiscal deficit to GDP ratio and the *change* in the BOP current account balance as part of a larger group of variables. Analyzing the change from the 1979-80 average to the 1981-82 average, countries were divided into a "high" and "low" subgroup for fiscal deficits. This analysis found a highly significant association between changes in fiscal deficits and changes in current account balances. Thus both studies, focusing on a disequilibrium setting when the overall fiscal deficit is a better proxy for excess demand, found more significant links between the fiscal and BOP current account deficits.

6. The issue of causality

Studies of the link between the overall fiscal deficit and the BOP current account balance have generally excluded the question of causality, that is, whether the fiscal deficit is said to cause the BOP deficit or vice versa. In this connection it might be helpful to ask what underlying model would provide a link between the two deficits. One plausible behavioral model would begin with excess government spending, leading to a widening fiscal deficit and greater demand for imports. In this model the line of causality runs from the fiscal to the BOP deficit. An opposite thesis, widely observed in practice, would emphasize the effect of an export shortfall, which in developing countries is closely tied to a decline in government revenue. This connection is based on the fact that foreign trade taxes alone are an important source of government revenue and, in addition, other taxes are indirectly affected by export fluctuations. A shortfall in exports, leading to a fall in imports, will adversely affect government revenue and lead to a wider fiscal deficit.[11] In this model the line of causality runs from the BOP to the fiscal accounts. In reality elements of both models are present at the same time in many developing economies, so that a complex interaction is taking place between the fiscal and BOP deficits.

7. "External" and "domestic" impacts on the balance of payments current account

A criticism of the "fiscal approach to the balance of payments" not so far discussed is that the theory implies a single cause view of current account BOP deficits, or at least the view that fiscal deficits are the dominant factor.

A recent study of the determinants of the current BOP balance of non-oil developing countries in the 1970s illustrates the use of a more realistic model to explain current account BOP deficits.[12] In this study both "external" and "domestic" factors (i.e. largely under the control of the authorities) are listed, although it is noted that a strict separation between the two is not possible. External factors affecting the current account balance include changes in the terms of trade, real growth in industrial countries providing markets for LDCs, and foreign real interest rates. Domestic factors include the real effective exchange rate and the fiscal deficit.[13] The study concluded that the most important single influence on current account disequilibrium in the non-oil developing countries was the deterioration in their terms of trade. Next in importance were fiscal deficits and movements in the real effective exchange rate.

8. Monetary measures of fiscal performance

A parallel approach to examining "fiscal" ratios of performance is to look for corresponding monetary measures. The net financing of the overall fiscal deficit by the banking system is the most obvious such measure. As in the case of the overall fiscal deficit, the increase in net credit to government has a connection to the overall balance of payments outcome via national income and monetary identities, and also has a theoretical basis in terms of the monetary approach to the BOP.

Subtracting net inflow of official and private capital from both sides of equation (2) gives:

$$Z-X-K_g-K_p=(I_p-S_p-K_p)+(I_g-S_g-K_g)=\Delta R \quad (9)$$

The overall BOP outcome (Δ R) is then expressed as equal to net domestic financing of the government and private sectors. If the BOP outcome is negative ($-\Delta$ R), the result implies an equivalent expansion in net credit to the public or private sectors.

The theoretical link between changes in credit to government and the overall BOP is also provided by the monetary approach to the BOP.[14] The monetary identity is as follows:

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[10] See Margaret R. Kelly, "Fiscal Adjustment and Fund-Supported Programs, 1971-80", *Staff Papers*, International Monetary Fund, Vol. 29, No. 4 (December 1982).

[11] For an exposition of this argument regarding export economies, see Charles Y. Mansfield, "A Norm for a Stabilizing Budget Policy in Less Developed Export Economies", *The Journal of Development Studies*, Vol. 16, No. 4 (July 1980).

[12] See Moshin S. Khan and Malcolm D. Knight, "Determinants of the Current Account Balances of Non-oil Development Countries in the 1970s: An Empirical Analysis", International Monetary Fund, DM/83/48 (June 1983). See also Khan and Knight, "Sources of Payments Problems in LDC's", *Finance and Development* (December 1983).

[13] Other "domestic" factors which might be important in particular circumstances could include interest rate policy, domestic pricing, credit policy, droughts, and other natural disasters.

[14] For a summary of the monetary approach to the balance of payments see Manual Guitián, *Fund Conditionality, Evolution of Principles and Practices*, IMF Pamphlet Series, No. 38 (International Monetary Fund, 1981). See also Vito Tanzi and Mario I. Blejer, "Fiscal Deficits and Balance of Payments Disequilibrium in IMF Adjustment Programs'," International Monetary Fund, DM/83/44 (June 1983).

$$Z-X-K_p-K_g = \Delta DC_p - \Delta M + \Delta NDC_g = -\Delta R\text{[15]} \qquad (10)$$

This monetary survey identity shows that the overall BOP surplus or deficit is equal to the increase in domestic credit minus the change in the money supply. The link between credit to government and the overall BOP outcome follows from the idea that, if the stock of money is at an equilibrium level, an increase in credit (often credit to government) will result in a loss of foreign assets.[16] From this point of view we can examine

$$\frac{\Delta NDC_g}{\text{GNP or GDP}}$$

as a summary measure of fiscal impact.

We can then consider

$$\frac{\Delta NDC_g}{\text{GNP or GDP}}$$

as an alternative measure to the ratio of the overall fiscal deficit to GNP, and the performance of this variable can be tested. This ratio can be considered a measure of the "monetized" portion of the fiscal deficit to GDP. The link between an increase in credit to government and the overall BOP outcome was tested by the equation:

$$\frac{\Delta FA}{\text{GNP or GDP}} = a + b\,\frac{\Delta NDC_g\text{[17]}}{\text{GNP or GDP}} \qquad (11)$$

The results are shown in Table 4. As shown in the table the link between the monetary variables is much closer than the link between the overall fiscal deficit and BOP current account. The monetary equation was found significant for 6 of 17 industrial countries and 58 of 90 developing countries. An alternative monetary measure of fiscal stabilization is to consider the ratio, $\frac{\Delta NDC_g}{G}$, that is, net domestic credit as a proportion of government expenditure. This ratio implies the familiar printing press model of government's expansionary impact on demand by financing expenditure through the banking system. When this ratio is regressed on the overall BOP outcome, the results are similar to the monetary measure shown (Table 4). Thus, both monetary measures appear to be more reliable than the measures underlying the fiscal approach to the BOP.

9. Measures of fiscal policy

A fundamental objection to the proxy measures so far presented is that they fail to distinguish between policy actions taken by the authorities and changes in the budget balance stemming from the rest of the economy. If reductions (improvements) in the GDP ratios of the overall fiscal deficit of bank credit to government are viewed "judgmentally," it would seem important to make this distinction. Thus, a reduction in the fiscal deficit (or bank credit) ratio to GDP may come about because a price increase in an export crop is reflected in a rise in tax revenues, or may be the result of a determined effort to cut government expenditure or increase effective tax rates. In the former case the deficit will return when export prices drop; whereas the latter case, reflecting policy actions by the authorities, may result in a permanent reduction in the deficit.

Table 4
Significant link between bank credit financing of fiscal deficit and overall balance of payments outcome

	Change in net credit to government related to overall BOP outcome[a]	*Change in net credit to government related to government expenditure*[a]
Industrial countries	6 of 17	7 of 18
Developing countries	58 of 90	41 of 63
Oil exporting	7 of 8	6 of 7
Africa	22 of 31	16 of 22
Asia	5 of 11	4 of 9
Europe	3 of 4	2 of 4
Middle East	5 of 7	3 of 4
Western Hemisphere	16 of 29	10 of 17

Source: *International Financial Statistics*. Countries in sample were correlated with *Government Finance Statistics* data at 95% level of significance or above for T ratio.

a. Significant link defined as T ratio significant at 95% level for null hypothesis that B = 0 in the following regressions:

$$(1) \quad \frac{\Delta FA}{\text{GNP or GDP}} = a + b\,\frac{\Delta C_g}{\text{GNP or GDP}}$$

$$(2) \quad \frac{\Delta FA}{\text{GNP or GDP}} = a + b\,\frac{\Delta C_g}{G}$$

where ΔFA = change in foreign assets;
ΔC_g = change in net credit to government; and
G = government expenditure.

(GNP used for industrial countries and GDP for developing countries.)

This criticism of the use of actual balance is clearly valid, but fiscal economists have yet to agree on an operational alternative. One line of thought has been to develop normative or implicit measures of the fiscal balance which can then be compared with actual results. The U.S. full employment budget surplus, used in the 1960s, showed that if output were at a full employment level revenues would have created a surplus in contrast to the actual deficit existing. The measure implied that a small actual deficit might be considered contractionary rather than expansionary, as a more conventional analysis would suggest. The German normative measure follows a similar line of thought. A more sophisticated technique originating in the Netherlands and used to separate fiscal policy changes from other changes in the budget is the "fiscal

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[15] Where K_p = net private capital inflow; K_g = net official capital inflow; DC_p = private domestic credit; NDC_g = net domestic credit to government; and M = money supply.

[16] Although the total increase in credit is stressed in formulations of the monetary approach to the BOP, the importance of the division between government and private credit has been noted. Thus, "the stronger is the crowding out effect of government credit for private credit the lesser will be the BOP impact of central bank financing of government deficits . . . there is a trade-off between compromising the achievement of monetary external stabilization targets, with the consequent BOP and inflationary results, and cutting down financing of the private sector, which leads to low growth and private investment." Tanzi and Blejer, "Fiscal Deficits and Balance of Payments Disequilibrium in IMF Adjustment Programs," International Monetary Fund, DM/83/44 (June 1983).

[17] Where ΔFA = change in net foreign assets; and ΔNDC_g = change in net domestic credit to government.

impulse," which has been described as follows: "This technique involves a distinction, with respect to government revenues and expenditure, between changes considered to be associated with cyclical fluctuations in an economy and other changes, which may be viewed as imparting expansionary or contractionary impulses to the economy independently of the more or less automatic responsiveness of government transactions to cyclical developments. Revenue is regarded as cyclically neutral when it grows in proportion to actual GNP at current prices, and is contractionary (expansionary) when it increases faster (more slowly) than actual GNP. Expenditure other than unemployment insurance benefits is regarded as cyclically neutral if it parallels the movement of potential GNP at current prices, and is expansionary (contractionary) when it increases faster (more slowly) than potential GNP. Year-to-year variations in unemployment insurance benefits are viewed as cyclically neutral; that is, merely reflecting cyclical developments in the economy. The net 'impulse' from changes in revenue and expenditure (i.e., that part of any net change in the fiscal balance that cannot be attributed to 'cyclically neutral' changes in revenue or expenditure) may be interpreted as a cyclically adjusted indicator .... of stimulative shifts in government fiscal operations. Such changes may be viewed as *policy determined* either by the introduction of new measures or by the operation of previously existing measures that automatically result in revenue or expenditure changes disproportionate to the change in GNP (or potential GNP) to which they are 'neutrally' related."[18]

These measures, applied to industrial countries, attempt to adjust the budget deficit to allow for cyclical changes as opposed to policy actions. This distinction has been carried further by Tanzi and Blejer, who point out that temporary measures may be taken in a given year to reduce the deficit, only to be reversed soon after. Such temporary actions include collecting anticipated future tax payments, collection of tax arrears, postponement of government payments to suppliers or employees, and sales of public property. These measures are often taken in developing countries, but may be found in industrial countries as well.[19]

Ideally speaking then, a reduction in the budget deficit that eliminated the impact of cyclical trends as well as temporary (reversible) policy actions, would identify changes in the "core" deficit that reflect a true change in fiscal policy. Such a measure could serve as a useful proxy for the impact of fiscal policy actions on the economy. However, measurement problems have so far precluded extensive policy use of these "fiscal policy" measures. Measures of the structural deficit (i.e., the deficit adjusted for cyclical changes) depend on a definition of potential output at full employment as well as the assumption that potential output is equivalent to "normal" output. In addition, the projection of what revenue would be at potential output requires an assumption concerning the elasticity of revenue to income. The definition of a core deficit, which would adjust the structural deficit to account for merely temporary changes in revenue and expenditure, would require a separation and measurement of "temporary" changes. These conceptual and measurement difficulties have kept the concepts of the structural and core deficits from attaining an exact meaning comparable to the actual deficit. However, any analysis of changes in the actual deficit must take at least a rough account of changes emanating from the rest of the economy as well as temporary policy changes, in order to arrive at a meaningful judgment on the impact of fiscal policy measures.

10. Summary and conclusions

This paper has focused on the uses and limitations of simple proxy measures of fiscal stabilization and tax effort performance. It has emphasized in particular that an implied model lies behind such measures, and the measures are most applicable when the implied model fits the economy in question. The most common measure, the ratio of the overall fiscal deficit to GNP or GDP, varies widely among countries, and the size of this ratio is not necessarily related to overall stabilization performance. In fact, this measure implies a model in which the overall fiscal deficit represents an accurate index of excess demand at a given exchange rate. If fiscal deficits to GDP or GNP are ranked, and a large fiscal deficit is considered an accurate indicator of excess demand, the model implies that all of the "pool of savings" is absorbed by private investment and/or net lending abroad. If this assumption were true for all countries any fiscal deficit would tend to exert pressure on the price level, the BOP and interest rates, depending on the degree of accommodation in monetary policy and the flexibility of the exchange rate. In actuality the amount of available savings absorbed by the private sector differs from country to country and, within a given country, differs according to the stage of the business cycle. Thus, an "equilibrium" overall fiscal deficit could vary widely among countries and between different points of time. These considerations lead to an emphasis on the financing of the budget deficit. As the budget deficit is financed in greater proportion by bank credit it becomes a more valid index of excess demand. Studies of disequilibrium economies making adjustment efforts, then, have been persuasive in showing that *changes* (reductions) in the level of the overall fiscal deficit often lead to corresponding reductions in the external current account. Such studies often have not addressed the thorny issues of causality in linking the overall fiscal and current account BOP deficits. Under plausible assumptions causality could run in either direction, and in a typical case could involve an interaction of an export shortfall leading automatically to a widening fiscal deficit, combined with increased fiscal expenditures raising the level of both fiscal and BOP deficits.

Monetary measures of fiscal performance are a much

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[18] International Monetary Fund, *World Economic Outlook* (1983), p. 110 (italics added).

[19] See Tanzi and Blejer, "Fiscal Deficits and the Balance of Payments Disequilibrium in IMF Adjustment Programs," International Monetary Fund, DM/83/44 (June 1983).

better predictor of overall stabilization performance. Two monetary measures, net credit to government as a ratio to GNP or GDP and net credit to government as a ratio of government expenditure, were found to be generally correlated with the overall BOP outcome in developing countries. The better performance of monetary measures, especially in developing countries, stems from the fact that these measures focus more directly on financing of the overall fiscal deficit. In fact, this closer connection is recognized in practice by the attention to monetary variables in International Monetary Fund programs. A basic criticism of such "actual" measures of fiscal stabilization performance, however, is that changes in the overall fiscal deficit (or a monetary equivalent, net credit to government) may come about because of policy measures, or may simply be the result of forces in the economy acting on the budget. If changes (reductions) in the fiscal deficit are used as a measure by which fiscal performance is judged, it is important to make such a distinction. So far, however, efforts in this direction have not resulted in a clear-cut alternative to the use of actual outcomes as a measure of performance. Efforts to construct a "structural" deficit (adjusting for cyclical effects in the economy on the budget) have been made for industrial countries, and have helped explain the direction of fiscal policy, as opposed to movements in actual budget balances. For developing countries, it would be important to adjust the actual deficit not just for changes in the economy, but for temporary policy changes which are reversed or only have their effect in a given year. Such an adjustment would result in a "core" deficit, and changes in the core deficit would reflect only the impact of more lasting policy actions by the authorities. Formulation of such a measure for developing countries is attainable in principle, but would entail formidable difficulties of measurement and judgment.

This examination of simple proxy measures of fiscal stabilization performance shows that such measures may be useful as a first approximation, but should be examined with care. First of all, the implied model behind the ratio should be made more explicit, and this implied model should be compared with the actual structure of the economy in question. In addition, a proxy measure of that part of the deficit due to fiscal policy actions alone would be very useful in judging performance, but is not readily available to the policymaker and requires extensive empirical work. In the absence of a genuine fiscal policy measure, interpretation of actual outcomes available should take into account, at least qualitatively, the impact of the rest of the economy on the budget.

IFA news

SWISS BRANCH

The Swiss branch of IFA reports that on 8 February 1985 a special meeting will be held in Basel. The subject to be discussed is the practical experience with international mutual assistance in tax cases. Prominent persons representing the tax administration, police, judiciary, business and universities will present reports.

The next meeting has been scheduled for 14 June in Zürich.

In next issues:

The Cameroon 1984/1985 Budget
– by *Michel Lecerf*

The Retail Sales Tax (Impuesto a las Ventas)
– by *Melissa H. Birch* and *Johan F. Due*

People's Republic of Korea: New Joint Venture Law

Zambia: Advantages Offered to Foreign Investment
– by *A.B.C. Emmanuel*

Guinea: New Investment Code
– by *Servaas van Thiel*

Brief Summary of Income Tax Assessment in Rwanda
– by *Charles Kalinijabo*

Foreign Sales Corporations (FSC) – A Survey of Selected Locations
– by *Patricia Dunn*

Taxation in Japan
– by *Torao Aoki*

Economic Cooperation in Central Africa[1]

Some Tax Aspects

By Servaas van Thiel

Mr. van Thiel is research associate at the International Bureau of Fiscal Documentation, Amsterdam.

1. INTRODUCTION

On 19 October 1983, 11 States of Central Africa[2] signed the Treaty for the Establishment of the Economic Community of Central African States (hereinafter ECCAS Treaty) in the capital of Gabon, Libreville.

The Treaty will enter into force thirty days after the deposit of the instruments of ratification by the 7th signatory state[3] and thereafter the Community must be established progressively over a twelve-year period subdivided into 3 four-year periods.

The Community has its own institutional framework in which the decision-making power is concentrated in the Conference of Heads of State and Government aided by the Council of Ministers in various compositions and a consultative commission. Executive power is vested in a General Secretariat. There is no direct democratic control on the Community institutions but legal control is exerted by a specially established Court of Justice which will inter alia "oversee" the legality of acts of Community institutions and decide on appeals by Member States on the grounds of lack of jurisdiction or infringement of the Treaty.

A Community Cooperation and Development Fund is established to provide financial and technical assistance so as to promote economic and social development of the Member States.

The 6 ultimate aims of the Community are to promote harmonious cooperation and a balanced and self-maintaining development in all fields of economic and social activity, to achieve collective self-reliance, to raise the standards of living of its peoples, to increase and maintain economic stability, to foster close peaceful relations between Member States and to contribute to the progress and development of the African continent.

In short, the Member States seek to further their development process by benefitting from the advantages of international economic integration.

International economic integration could be defined as the process of growing density in economic contacts between geographical areas. It is actively encouraged by many governments because it is thought to allow productive resources to be allocated to their most productive uses thus optimising efficiency and welfare (allocative efficiency) and furthering equity and stability. Economic integration between free market oriented or mixed economies implies an integration of the relevant economic markets into one common market and the establishment of a common economic and monetary policy within the union as well as towards the outside world.

The integration of the relevant economic markets includes the establishment of a common market for products as well as the establishment of common markets for production factors such as labor and capital. Accordingly the ECCAS Treaty provides for the establishment of a customs union and the abolition of obstacles to the free movement of persons (including the right of establishment), services and capital.

The establishment of a common economic and monetary policy implies the harmonization of the various national policies. The ECCAS Treaty provides for cooperation between Member States in many economic sectors such as agriculture, energy and natural resources, infrastructure, transport and communication, industry and tourism as well as in various areas of social and monetary policy (human resources, education, science and technology).[4]

Because taxation plays a significant role in the integration of various economic markets this article will deal with this aspect of the ECCAS Treaty rather than with the establishment of common socio-economic and monetary policies.

2. THE HARMONIZATION AND A COMMON MARKET FOR PRODUCTS

The establishment of a common market for products requires a dismantling of all internal barriers to trade in order to have a free flow of goods. Non-tax barriers include quantitative restrictions, technical trade barriers, import and export procedures etc. The ECCAS Treaty therefore provides for the progressive elimination of quota's and other non-tariff restrictions to trade and for the harmonization and simplification of intra-community customs procedures.[5] Tax barriers include customs

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[1] "Treaty for the Establishment of the Economic Community of Central African States" published in 23 *International Legal Materials* 5 of September 1984 at 945.

[2] Participating states are Angola, Burundi, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon, Rwanda, Sao Tome and Principe, Zaire.

[3] The Government of Gabon is the depositary Government.

[4] See Protocols 9 to 16 annexed to the Treaty.

[5] Separate protocols govern the rules of origin (1), non-tariff trade barriers (2), re-export of goods (3), transit traffic (4), customs cooperation (5), and simplification and harmonization of trade documents and procedures (12).

duties, excise duties, discriminatory treatment in national tax structures of imported and domestically produced goods etc.

Consequently the ECCAS Treaty first of all provides for the elimination of internal customs duties and the gradual adoption of a common external customs tariff.

A standstill clause prohibits Member States to introduce any new customs duties or to increase existing ones in the first four-year stage of the integration process. From the end of the first stage onwards the Member States must progressively reduce and eventually eliminate all intra-community customs duties as well as all differences in their respective customs tariffs towards third countries. Thus at the end of the second stage intra-community tariffs must be eliminated and at the end of the third stage a common customs tariff and nomenclature must have been adopted.

Second, a Compensation Fund is established in order to refund "loss of revenue", due to elimination of tariffs on intra-community trade. Loss of revenue is defined as the annual difference in revenue of a Member State between the total customs duties and charges that would result from most favored (third) nations treatment of intra-community imports and any customs duties and charges levied under the Treaty. The Compensation Fund is funded by payments made by Member States for the loss or revenue (of other Member States) arising from their export to other Member States. The actual annual payment therefore will be the difference between compensation due for imports into a Member State and the compensation which that Member State owes for its exports to other Member States. However, certain products, to be determined by the Council, are completely customs free and cannot give rise to loss of revenue.

Thirdly, Member States are prohibited to apply taxes, directly or indirectly, to imports from other Member States in excess of those applied to domestic goods. Any taxation for the effective protection of domestic goods must be eliminated.

Thus the Treaty clearly provides for the harmonization of indirect taxes to facilitate the flow of goods and because of the important role of these taxes in the revenue of developing countries it also provides for a compensatory arrangement.[6]

3. TAX HARMONIZATION AND A COMMON MARKET FOR PRODUCTION FACTORS

The traditional theory of economic integration has mainly concentrated on the creation of free trade under the assumption of production factor immobility, thus focussing on the free flow of products and disregarding the free flow of capital and labor. Consequently tax harmonization mainly involved the removal of customs duties and discriminatory treatment between imported and domestically produced goods (indirect tax harmonization). Free flow of goods is, however, only part of economic integration of which free movements of persons and capital and the integration of economic policies are the other parts.

The free flow of persons requires the unrestricted right of individuals and legal persons to establish themselves and to conduct business or perform labor in all countries of the community. Non-tax barriers include immigration restrictions, work permit conditions, licensing and establishment requirements etc. The ECCAS Treaty stipulates the unrestricted right of entry and establishment in all Member States of all individuals and legal persons from all other Member States. Protocol VII provides for the gradual abolition of obstacles to the free movement of persons and services upon establishment within the Community. It also provides for the coordination of social and commercial laws to this end.

Tax barriers include different personal and corporate income tax burdens and social security systems. The ECCAS Treaty makes no specific reference to these tax barriers.

The free flow of capital implies free access to various capital markets as well as free flow of investments within the community. Non-tax barriers include restricted access to stock markets, foreign exchange restrictions and differences in other aspects of the investment climate. Tax barriers include differences in effective tax burdens on investment income (whether resulting from differences in tax liability, bases of assessment, deductions, rates allowances or otherwise) as well as double taxation.

The ECCAS Treaty only provides for the harmonization of financial policies (including the creation of a Clearing House) and for the progressive coordination of national exchange policies with regard to intra-community capital movements. It does not include a specific chapter dealing with the obstacles to the free flow of capital and investments, notably the harmonization of income tax burdens and the avoidance of double taxation.

However, interesting references to tax harmonization are made within the framework of the Chapters on "Industrial Cooperation" (Art. 46) and "Cooperation in other fields" (Art. 69). In Art. 46 Member States agree to "harmonize measures for stimulating industrial development by gradually establishing a homogeneous industrial environment in the sub-region, inter alia by the preparation of a common investment code.[7] This probably includes the harmonization of tax treatment of investments although it is not clear whether this would only cover tax incentives as usually granted in investment codes or whether it would also cover the more common features of income and other taxes.

In Art. 69 Member States agree to "harmonize within 4 years from the date of entry into force of the Treaty,

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[6] In this respect the ECCAS differs markedly from e.g. the EEC where customs receipts form a part of the Community's own resources out of which the costs of common policies and administration are paid. The ECCAS follows more the traditional structure of an international organization where the annual budget is funded by contributions of Member States.

[7] At the moment the investment codes of the countries involved are very different and some countries do not have a code at all. On the other hand, the formulation of a common investment code could be facilitated by the experience of the U.D.E.A.C. countries where such a common code has already been applicable since 1965. U.D.E.A.C., Act No. 18-65 adopting a Common Investment Code. Journal Officiel of 3 March 1966.

their tax laws, notably with regard to determination of rates and to the levels of indirect taxes other than customs duties, in order to favor the establishment of businesses in the Community".

This clause, although not directly referring to income and other taxes influencing the free flow of investments, could easily be used for harmonization of those taxes because the first part refers to "taxes" in general. Moreover the second part, starting with the word "notably" contains a non-exhaustive enumeration of which again the first part relates to "rates" in general whereas the last part refers to the favoring of the "establishment of businesses in the Community". This is an indirect reference to intra-community investment flows. Thus the Treaty does not clearly provide for the harmonization of mainly direct taxes in order to facilitate the flow of production factors but those harmonization measures could well be realised by the Community under more general economic cooperation clauses which do refer to taxation.

4. CONCLUSION

The ECCAS Treaty follows the more traditional pattern of economic integration putting the emphasis on free trade and a common market for products rather than on the free flow of production factors. Consequently, the harmonization of indirect taxes is more important than the harmonization of direct taxes although on the other hand attention is given to a regional investment code and to the harmonization to favor the establishment of businesses.

Apart from the realization of free trade the Treaty emphasises the harmonization of wide areas of economic and social policy. This may not be surprising in an economic union of developing countries because public interference with economic development is much more important than in free market economies. On the other hand it will not be an easy task to harmonize various economic policies of countries so different as Angola, Zaire and Sao Tome. This is complicated by the fact that the original Treaty leaves the more detailed arrangements to the institutions where ultimate decision making power is concentrated in a Conference which decides with unanimity. In general it must be said that the aims of the Treaty are quite far-reaching and ambitious. As such it differs from the more partial and pragmatic approach of recent schemes of integration in East Africa notably the Preferential Trade Area.[8] This may be a reflection of the respective predominant francophone and anglophone background of the regions; in any case it is quite positive that regional economic cooperation is widely recognized as an engine of growth and development.

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[8] The Preferential Trade Area presently groups 14 states of Central and East Africa (Burundi, Comores, Djibouti, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Rwanda, Somalia, Swaziland, Uganda, Zambia and Zimbabwe). The Member States apply reductions in customs duties or dismantle these duties on trade between themselves. They also use local currency or barter trade in an attempt to save local currency.

AUSTRALIA:

Interest Withholding Tax

Statement by the Treasurer, the Hon. P.J. Keating M.P., on 14 December 1984.

The Government has decided that the income tax law should be amended to strengthen the interest withholding tax provisions of that law. These provisions impose a final liability to income tax, at the rate of 10%, on amounts of interest, as well as amounts in the nature of interest, derived by non-residents from sources in Australia.

There has been a significant move away from the more conventional means by which overseas finance is provided, and which give rise to common interest, with the aim of avoiding the non-resident lender's liability to Australian withholding tax.

A popular arrangement is the provision of finance by means of a bond that is issued by the resident borrower at a discount and that is redeemable for its face value some time later. Instead of holding the bond until redemption – and thus being liable to withholding tax on the discount benefit, which would be in the nature of interest – the non-resident lender sells the bond shortly before redemption to a resident for a price marginally below the face value. The purchaser may be liable to tax on the excess of the amount received on redemption over the purchase price paid, but the balance of the discount, which is effectively passed to the non-resident lender as part of the proceeds on sale of the bond, cannot be subjected to withholding tax. Nor can the profit to the non-resident from the sale be taxed by assessment, as the arrangements are such that the profit has an ex-Australian source.

Other techniques aimed at avoiding Australian withholding tax involve the use of debt obligations such as capital indexed and deferred interest securities. Another recent development is the issue of securities such as Dingo bonds which, although designed to defer payment of tax, can give rise to avoidance of withholding tax in the manner described above. These bonds are marketed separately as entitlements to the principal and interest components of underlying Commonwealth securities. They are themselves issued as principal obligations at a discount and, on maturity, the investor receives the value of the underlying principal or interest component of the Commonwealth security.

These arrangements pose a substantial threat to withholding tax revenue. It has therefore been decided to amend the law to ensure that discounts and other pecuniary benefits derived by non-residents in relation to financing by way of discounted debt obligations (such as bonds, bills, debentures, notes, mortgages, etc.) and by way of capital indexed and deferred interest securities are brought within the scope of its withholding tax provisions.

Where such a debt obligation or security is redeemed from, or matures in the hands of, a non-resident holder, the withholding tax provisions of the law will apply to the difference between the amount so receivable by the non-resident and the original issue value of the obligation or security. Where such a debt obligation or security is purchased by a resident from a non-resident, the provisions will apply to the difference between the purchase price and the original issue value of the obligation or security. Appropriate withholding tax will, of course, be required to be deducted from the relevant payments.

It will be open to the non-resident charged withholding tax in these circumstances to establish that the obligation or security in question had been purchased directly from a resident and, on that basis, apply to the Commissioner of Taxation for adjustment of the tax charged. In such a case, the withholding tax would be adjusted to bear on the difference between the proceeds from the transaction in the hands of the non-resident and the purchase price paid by that non-resident to the resident.

These measures will apply to payments made in respect of relevant debt obligations and securities issued after today but, subject to legislative safeguards against abuse, will not affect payments made on or before the date on which the legislation implementing the measures is enacted.

Apart from these debt obligations and securities, hire purchase and similar arrangements – such as "terms purchase" and "lease with option to purchase" arrangements – are being used as a means of avoiding interest withholding tax. The charges payable under these arrangements are not classed as interest for withholding tax purposes but are, in reality, a return for the provision of finance.

Instead of obtaining conventional finance for the purchase of plant or equipment from overseas, which financing would normally give rise to common interest subject to withholding tax in the case of a non-resident lender, or subject to tax by assessment in the case of a resident lender, Australian entities are purchasing plant or equipment under hire purchase and similar agreements with non-residents. By effectively substituting the charges under the agreements for common interest, the return to a non-resident "lender" is not subject to withholding tax and – because the particular arrangements do not enable an Australian source to be attributed to those charges – not subject to tax by assessment.

The income tax law is to be amended to bring hire purchase and similar charges – that is, the excess of total payments made under the relevant arrangement over the cost price of the goods, etc. that are the subject of the arrangement – within the scope of the interest withholding tax provisions. This amendment will apply in relation to contractual obligations entered into after today. However, again subject to safeguards provided in the legislation, relevant payments made on or before the legislation is enacted will not be affected.

TAXATION LAWS IN MALAYSIA AND THEIR IMPLICATIONS TO BUSINESS

A one-day seminar on taxation aspects of doing business within Malaysia

22 MARCH, 1985

ROYAL, Pavilion Inter-continental, Singapore

Asian-Pacific Tax and Investment Research Centre, a Singapore based independent non-profit research and documentation institute, is holding a one-day seminar on "Taxation Laws in Malaysia and their Implications to Business" on 22nd March, 1985, at the Pavilion Inter-continental, Singapore. The purpose of this seminar is to discuss the crucial aspects of taxation in Malaysia in the light of the continued *changing tax scenario* and *to see as to how and in what manner it affects business operations with/in Malaysia.*

HIGHLIGHTS

- Tax developments in Malaysia as they impact international investment.
- Recent developments in tax legislation in Malaysia.
- Taxation of corporate income with particular reference to foreign income of residents, and non-residents with income in Malaysia.
- Share (land based company) transfer tax: scope and effects.
- Investing through joint ventures: tax and accounting considerations.

PROGRAMME

Chairman: Mr. Sidney C. Rolt, Financial Consultant, Singapore.

09.00 *Key Note Address*

Tax developments in Malaysia as they impact international investment.

Speaker: *Mr. Raja Abdul Aziz,*
Director General Inland Revenue Department,
Malaysia.

09.45 Recent developments in tax legislation

- Explanation of tax implications of the 1985 Budget.
- Recent Practices adopted by the Inland Revenue Department that may affect a taxpayer.
- Recent decided Malaysian tax cases.

Speaker: *Mr. Lee Beng Fye,*
Director, Price Waterhouse, Malaysia.

11.00 COFFEE BREAK

11.15 Taxation of corporate income with particular reference to foreign income of residents, and non-residents with income in Malaysia.

- General principles of taxation
- Source vs domicile/residence
- Computation of income
- Treatment of losses
- Branch vs subsidiary
- Withholding taxes
- Tax incentives
- Double tax relief
- Taxes other than income taxes

Speaker: *Mr. Graham R. Clark,*
Ernst & Whinney, Singapore.

12.30 LUNCH BREAK

14.00 Share (land based company) transfer tax: scope and effects.

- General principles
- Scope of charge
- Assessment and rate of tax
- Exemptions
- Valuation
- Returns and notifications, deduction of tax by acquirer, refunds, etc.
- Appeals

Speaker: *Datu Kok Wee Kiat,*
Moh Kok Din, Advocates, Kuala Lumpur, Malaysia.

15.15 Investing through joint ventures: tax and accounting considerations.

- Selecting the right form of joint venture
- Methods of accounting
- Tax reliefs and incentives available to joint ventures
- Transfer pricing, withholding tax and profit repatriation
- Effect of the double taxation treaties.

Speaker: *Mr. Beh Tok Koy,* Tax Director,
SGV-KC Taxation Services Sdn. Bhd., Kuala Lumpur,
Malaysia.

16.15 Panel discussion

17.30 Close of the Session.

WHO ATTENDS

The subject should be of interest to corporate decision makers, tax advisers and academics.

CONFERENCE FEE

SGD 400 per delegate including conference material, refreshments and lunch. No extra charge for substitute delegates.

20% discount for Centre's members and for firms sending two or more delegates.

COURSE MATERIAL

Extensive course material will be presented to delegates at the Seminar. If possible, material will be despatched earlier.

U.K. Tax Congress 1984

By Joanna C. Wheeler

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The 1984 U.K. Tax Congress was held in the Wembley Conference Centre in London on 6 and 7 December 1984. During the two days of the Congress the 800 participants could attend 4 general sessions and choose 5 out of 15 concurrent sessions. The delegates seemed to come mostly from small to medium-sized firms and businesses, although it was difficult to judge the precise numbers from various sectors as no list of delegates was available.

The first day started with a short concert given by the band of the Coldstream Guards. This was obviously too much at that time of day for many delegates, judging from the numbers who studiously ignored the announcements and waited by the coffee table until it was over. The work started immediately afterwards with a review of developments in 1984/85 given by Nigel Eastaway and Jack Harper. As the year had been such a busy one many developments could only be briefly mentioned, but the speakers found time, nevertheless, to comment on some topics. Nigel Eastaway explained the controlled foreign company legislation in the Finance Act 1984[1] and the problem which prompted the Board of Inland Revenue to publish a consultative document on dual resident companies[2] at the end of the year. He discussed the consultative document on the taxation of partnerships, of which he had several criticisms. One major criticism was that the document appeared to have been based on a sample of only 13 of the larger partnerships. He also talked briefly about the legislation in the Finance Act 1984 on deep discount securities,[3] defined as redeemable securities issued at a discount satisfying certain conditions. The legislation treats part of the disposal proceeds as income rather than a capital gain, with the normal disadvantageous consequences. Some types of security, however, are exempted from this treatment, including securities where the amount payable on redemption is fixed by reference to the retail prices index of a foreign government. Mr. Eastaway pointed out that securities linked, for example, to the Argentinian retail prices index provided rather interesting tax planning opportunities!

Jack Harper then took over the introductory presentation. He spent some time talking about the "pref. trick" scheme to avoid stamp duty and the question of whether it was now made obsolete by the House of Lords' decision in *Furniss v. Dawson.*[4] He said that there were some cases from the 1960s which established that purpose is irrelevant for stamp duty purposes and predicted that the "pref. trick" is not dead yet. He also discussed the Keith Committee's recommendations with respect to Value Added Tax, which he found to be unfair to the trader. He gave the example of a trader who incorrectly thinks that a product is zero-rated (exempt with credit) and who, under the Keith proposals, would automatically be liable for a surcharge as a result of his mistake. Mr. Harper thought that there should at least be a cleareance procedure available for such cases.

The introductory talk was followed by some of the concurrent sessions, and the first day finished with a panel of speakers answering questions from the floor. Various interesting points were raised, but unfortunately the questioners tended to refer to the working sessions held earlier during the day, so that those who had not attended that particular session were sometimes left rather in the dark.

The second day started with a case study on tax planning with respect to the family business. Andrew Thornhill and Robert Venables presented the study in a clear and concise way and the many practical points they highlighted were obviously well received by the delegates.

The last general session, at the end of the second day, was another case study, this time on the Business Expansion Scheme[5] presented by Brian Armitage. Mr. Armitage assumed that the delegates knew the basic principles of the scheme, and devoted the time available to highlighting some of the pitfalls in this complex area of legislation. As with the earlier case study, it was obvious that the delegates found this session very valuable.

The other working sessions of the Congress were each split into 3 concurrent groups, so that it was impossible to attend all the sessions. One of the first sessions was about artificial transactions in land, presented by Ronald Gulliver. The title of the session referred to a particular provision in the U.K. legislation[6] designed to nullify tax benefits arising from such transactions. Mr. Gulliver's presentation consisted of a sub-section by sub-section analysis of that provision, which taxes as income gains arising from transactions in land which the legislation characterizes as "artificial". The section obviously applies to land in the U.K., but Mr. Gulliver said that there was no known answer to the question whether land outside the U.K. held by a U.K. resident was affected. He also pointed out that this provision is often applied to non-residents because it is the only provision which the Inland Revenue can use in such cases.

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[1] The consultative documents published on this subject by the Board of Inland Revenue and some of the responses to those documents were reproduced in 21 *European Taxation* 2 (1981) at 56, 8 (1981) at 239, 9 (1981) at 289, 10 (1981) at 319, 12 (1981) at 383, 22 *European Taxation* 10 (1982) at 332, and 23 *European Taxation* 3 (1983) at 91. The draft clauses proposed in October 1983 were discussed in 24 *European Taxation* 3 (1984) at 75 and the 1984 Budget proposals in 24 *European Taxation* 4 (1984) at 129. A list of countries not affected was reproduced in 24 *European Taxation* 6 (1984) at 202. The legislation in its final form was described in 24 *European Taxation* 11 (1984) at 372. See also TNS (1984) 78, 132.

[2] Reported in TNS (1984) 203.

[3] The Budget proposals and enacted legislation were described in 24 *European Taxation* 4 (1984) at 129 and 11 (1984) at 372 respectively.

[4] The Treasury's view was reported in TNS (1984) 153. The case of *Furniss (Inspector of Taxes) v. Dawson* was discussed in 23 *European Taxation* 9 (1983) at 302 and 24 *European Taxation* 4 (1984) at 134.

[5] The Business Expansion Scheme was described in 23 *European Taxation* 6 (1983) at 201 and 24 *European Taxation* 1 (1984) at 26.

[6] Income and Corporation Taxes Act 1970 (ICTA) Sec. 488.

After lunch on the first day there was a new group of concurrent sessions, including a presentation on transfer pricing given by Iain Stitt. The U.K. legislation on transfer pricing consists of one provision in the Taxes Acts,[7] as the U.K. does not have any regulations on this point and very little case law. Because of this, it can be useful to look at the application of the equivalent provision in other countries. The 1979 OECD report on transfer pricing is also useful, as the Inland Revenue played a large part in putting the report together. Mr. Stitt pointed out, however, that the Inland Revenue tends to use the "global" method of apportionment, even though the OECD report rejected it. Mr. Stitt went on to talk about the practical points involved in the application of the transfer pricing provisions. Many of the practical problems arose because the two fiscal authorities dealing with one transaction do not necessarily take the same point of view. It was not unknown for two authorities to want to adjust a transaction in different directions. Most double taxation agreements include a mutual agreement procedure, but this normally only obliges the two authorities to "endeavour" to reach agreement. The Inland Revenue is reluctant to use this procedure and rarely does so. If it does so, the taxpayer is not often involved, unlike the normal case in the United States, for example. Another disadvantage of the procedure is that it can lead to an exchange of information between the two authorities concerned. Sometimes the authorities collect transfer pricing claims and trade them off against each other, in a similar fashion to the "knock-for-knock" agreements concluded by insurance companies. Mr. Stitt suggested that if all else fails, double taxation may be reduced by the payment of dividends from the unadjusted profits.

One of the concurrent sessions in the first group of three on the second day was a presentation by Patrick Soares on an anti-avoidance provision dealing with transactions in securities.[8] This was another section in the Taxes Acts which allows the Board of Inland Revenue to rewrite deals to convert capital gains into income, or to disallow a loss in dividend stripping transactions. There is no provision expressly prohibiting the imposition of a tax charge on the gain and the "income" simultaneously, but Mr. Soares said that the House of Lords has warned that the Inland Revenue should not try to do that. Mr. Soares went on to devote most of his presentation to a series of examples of decided cases, explaining the facts and the reason for the decision. In his conclusions he said that there were two classical danger areas: one was trying to liquidate a company but keep the business going; the other was selling one family company to another family company.

The last group of concurrent sessions included a presentation by Nigel Eastaway on U.K. withholding taxes, in particular the provisions relating to interest and royalties. Mr. Eastaway spent some time on the definition of an "annual payment", as it is the classification of a payment as "annual" which generally triggers off the withholding mechanism. In order to be an annual payment, the payment must be pure income profit, which excludes, for example, royalties paid for the use of a trademark if the owner is obliged to advertise the trademark. Royalties for the use of a patent are, however, specifically treated by the legislation as annual payments.

The presentations made during the concurrent sessions were generally of a high standard; the main criticism being that too little time was allotted for them so that the speakers were cut short just as the session was becoming interesting. For this reason, maybe, little new material was introduced, but this is not to say that the sessions were not useful. On the contrary, it was very valuable to have the law relating to the topics dealt with drawn together and presented in a concise form. The sessions dealing with single legislative provisions also served to draw attention to some areas of law which may not crop up every day but which are, nevertheless, important.

The Congress was well organized and all the events ran smoothly and on time. An impressive array of speakers took care of the working sessions. Several "fringe" events were also included, such as the finals of the "Taxmaster '84" quiz, with four contestants displaying their knowledge of tax law in extremely nerve-racking circumstances. This was supposed to provide relaxation for the audience, but many of them obviously suffered from sympathetic nervousness instead. The Tax and Investment Exhibition attached to the Congress was the largest to date and had an interesting variety of stands. All in all, the Congress proved to be an interesting and worthwhile two days.

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7. ICTA Sec. 485.
8. ICTA Sec. 460.

INTRA–ARAB INVESTMENT

A symposium on taxation treatment of foreign Arab investments in Arab countries

Amman, Jordan – 22-23 October (1984)

The Secretariat of the Arab league and the Inter–Arab Investment Guarantee Corporation* co-sponsored the symposium. Chief among its objectives was an examination of the role of taxation in influencing the flow of foreign investment. Another goal was to give participants an opportunity to exchange experience, especially among government tax administrators, with the aim of encouraging a greater degree of homogenity among the tax laws of the countries concerned. The symposium was also intended to serve as a medium for viewing tax treatment from the perspectives of both the investor and the tax administrator. (Airing of grievances on both sides was seen as a practical way of structuring the relationship.)

Government experts and tax officials from nearly all the Arab countries participated in the symposium. In addition, the following Arab and Islamic international organizations and instutions were represented:

1. The council of Arab Economic Unity
2. The Arab Fund for Economic and Social Development
3. The Arab Monetary Fund
4. The Organization of Arab Petroleum Exporting Countries (OAPEC)
5. The Arab Organization for Agricultural Development
6. The Arab Organizationf for Administrative Sciences
7. The Islamic Development Bank
8. The Federation of Arab Chambers of Commerce, Industry and Agriculture
9. The Gulf Co-operation Council and
10. The Federation of Arab Banks

The International Bureau of Fiscal Documentation was also represented as well as Arab joint ventures, Arab investment companies and private experts concerned with investment and taxation.

The symposium adopted the following recommendations:

1. Policies, to encourage investment in general and to give tax incentives in particular, should be aimed at activating monetary flows geared towards economic and social developments, meeting payment deficits and attracting revenues from money currently invested abroad.
2. For tax incentives to be effective they have to be in harmony with the other elements of investment treatment. Overly generous tax incentives may generate skepticism and thus be counterproductive. On the other hand, provisions that may detract from or abrogate tax incentives will have a negative impact on the investment climate.
3. Tax is still a basic source of revenue for many Arab countries. However, the loss of revenue that a country sacrifices in providing tax incentives should not exceed the anticipated outcome from foreign investment in terms of fulfilling the host country's development objectives. A balance should be struck between encouraging foreign investment and promoting internal development.
4. It is difficult to set a model for taxation treatment of foreign investment that is suitable for many different countries. However, there are some principles which must be observed in adopting a tax system if it is to accomplish its objectives. Among these principles are:

   a) A tax system should be the outcome of careful study to ensure its stability. When an amendment is dictated by change of circumstances, rights acquired prior to such amendment should not be disturbed.

   b) The tax system should not discriminate among equals except for an objective, clear and acceptable purpose.

   c) Drafting of tax provisions should be very clear to negate differences in interpretation.
5. The limited response to tax incentives can be attributed more to the tax administrators' rigid way of interpretation of the tax provisions in favor of the treasury, regardless of the spirit of the law and the goal of the legislator, than to the actual extent of the tax incentives themselves. Hence the necessity of upgrading the quality of the tax administrators.
6. Stability of treatment of investment in general and of its tax treatment in particular has a strong appeal to financial and investment institutions.
7. For the desired tax system to be effective it has be supplemented by simplification of bureaucratic procedures required of potential investors.
8. In conformity with the objectives of the Unified Convention for Investment of Arab Capital in Arab Countries, Arab investment laws should give Arab investors more privileged treatment than they accord non-Arab foreign investors. In addition Arab joint ventures that are integral and productive prtojects which meet basic needs should be singled out for very special favorable treatment.
9. In the context of promoting, inter-Arab trade, tax can play an effective role in encouraging industries geared for exports by providing special input and output incentives.
10. It is desired that field research be conducted to study the relative effect of tax treatment on the flow of Arab foreign investment in relation to other determinant factors.
11. Field research is also important for determining the actual tax burden on foreign investment in the various Arab countries. This may contribute to harmonization of tax laws among the Arab countries.
12. A thorough study needs to be undertaken to properly assess the experience of the tax-free zones.
13. If double taxation is not already an urgent problem for the Arab countries, its negative impact is bound to gradually increase with increased monetary and economic developments in the Arab world.
14. The Arab countries that have not yet ratified the Unified Convention for Investment of Arab Capital in Arab Countries and the Convention for Facilitation and Promotion of Inter-Arab Commercial Exchange are requested to take the necessary steps to do so.
15. The participants hope that similar seminars will be held to study the different aspects of treatment of investment as this could precipitate practical suggestions that will make the general Arab investment order complete.

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* The I.A.I.G.C. is an international Arab organization that insures Arab investments in other Arab countries against non-commercial risks. It has its seat in Kuwait.

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Dublin, The Institute of Taxation in Ireland [address see above], 1984. 413 pp.
This third edition of the taxation of capital gains includes amending provisions in the 1984 Finance Act. The book is a detailed study of the general principles and computation of capital gains tax. It includes special sections on shares and securities, leasehold interests and company chargeable capital gains.
(B. 105.736)

BALE, Norman; CONDON, John.
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Finance Act 1984 edition.
Dublin, The Institute of Taxation in Ireland [15 Fitzwilliam Square, Dublin 2], 1984. 290 pp.
This textbook is a guide to the law and practice involved in the capital acquisitions tax in Ireland. This edition includes the most recent and rather major amendments made to CAT by the 1984 Finance Act. The book contains detailed examination of the working of CAT with many computations and other provided examples.
(B. 105.735)

O'CONNOR, Michael; CAHILL, Patrick S.
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This book is an up to date study of stamp duties in Ireland. It includes examination of the categories and principles of stamp duties, administration of the system as well as the stampable instruments and the rates of duty.
(B. 105.734)

Italy

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Norme generali.
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Milan, Camera di Commercio Industria Artigianato e Agricoltura [Via Meravigli 9/B], 1984. 1285 pp.
Systematical compilation of the laws regarding trade on the international level.
(B. 105.746)

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(B. 105.803)

Liechtenstein/Switzerland

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Luxembourg

BERNARD, Guy.
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Aspects juridique, fiscal et comptable.
Etudes Economiques Luxembourgeoise.
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Monograph describing the holding company concept and its taxation in Luxembourg.
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Netherlands

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Bespreking van het rapport van de Commissie ter bestudering van de fiscale aspecten van samenlevingsvormen.
Geschriften van de Vereniging voor Belastingwetenschap No. 163.
Deventer, Kluwer, 1984. 32 pp.
Discussion on the report of the Committee to study the tax aspects of the kinds of households (Part two).
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Rapport van de Commissie ter bestudering van de fiscale behandeling van wisselende inkomsten.
Geschriften van de Vereniging voor Belastingwetenschap No. 164.
Deventer, Kluwer, 1984. 124 pp.
Report of the Committee to study the tax treatment of changing taxable income derived by individuals with reference to theoretical background information.
(B. 105.726)

PENSIOEN.
Amsterdam, Klynveld Kraayenhoff & Co., 1984. 354 pp.
Monograph prepared by Klynveld Kraayenhoff & Co. describing various aspects on old age pensions including the tax aspects.
(B. 105.755)

WASCH, E.P.J.; JACOBS, G.J.M.
Heffingen verontreiniging oppervlaktewateren.
Deel I. Formeel recht.
Fiscale brochures FED. Diversen 4.
Deventer, FED, 1984. 107 pp., 36,50 Dfl.

Monograph in the series Fiscale brochures FED dealing with the charges on polluted surface waterways in Dutch tax law.
(B. 105.724)

GRAPPENHAUS, Ferdinand H.M.
Alva en de tiende penning.
Deventer, Kluwer, 1984. 399 pp.
Second edition of a political, fiscal, economical and social description of Holland during the sixteenth century with emphasis to the tenth coin for the Spanish ruler in those days. Except for some corrections of misprints the second edition equals the first edition.
(B. 105.772)

COMMERCE AND INDUSTRY IN
The Netherlands.
Eleventh edition.
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Eleventh edition of guide describing commerce and industry in The Netherlands.
The taxation, customs duty and import duties are also dealt with.
(B. 105.815)

Poland

WERALSKI, Marian.
Financial Law.
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(B. 105.759)

Spain

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Madrid, Peat Marwick [Serrano Jover 5, Madrid-8], 1984. 98 pp.
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Eidg. Steuerverwaltung, Abt.
Statistik und Dokumentation, 1984.
Loose-leaf publication in the new series "Steuern im Ausland" (Taxes abroad) prepared by the Federal Tax Administration of Switzerland providing an outline of the taxes in Sweden.
(B. 105.771)

DECISION 956-1984 OF THE SUPREME
Administrative Court on the applicability of the Anti-Avoidance Clause.
Stockholm, Supreme Administrative Court, 1984. 13 pp.
Appeal by the taxpayers against an Advance Ruling on the question whether certain transactions (gift of real property and subsequent sale of the same property) would fall under the Anti-Avoidance Clause, i.e. Section 2 of the Anti-Avoidance-Act.
(B. 105.752)

Switzerland

HORN, Ernst.
Handbuch des internationalen
Steuerrechts der Schweiz.
Bern, Verlag Paul Haupt [Falkenplatz 14, 3001 Bern], 1984. 502 pp., 108 Sfr.
Handbook designed to provide a comprehensive analysis of Swiss international tax law.
Various authors set out the important aspects of Swiss basic principles of international tax law (federal, cantonal and municipalities) and the provisions in the concluded treaties by Switzerland with respect to income tax, net worth tax, gift and death duties with reference to OECD Model Convention and reference to literature or where appropriate with examples.
(B. 105.745)

ÖFFENTLICHE FINANZEN DER
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Eidgenössischen Finanzverwaltung.
Statistische Quellenwerke der Schweiz Heft 771.
Bern, Bundesamt für Statistik [Hallwylstrasse 15, CH 3003 Bern], 1984. 157 pp.
Statistical data for 1982 on revenue and expenditures of the Confederation, the Cantons and the Municipalities.
(B. 105.733)

United Kingdom

STANLEY, Oliver.
Taxation of farmers and landowners.
Second edition.
London, Butterworths, 1984. 363 pp., £ 18.00.
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(B. 105.768)

GUIDE TO THE FINANCE ACT 1984.
London, Arthur Anderson & Co., 1984. 40 pp.
Considerations of the most important aspects of the Finance Act 1984 except changes relating to oil taxation.
(B. 105.754)

PENNINGTON, Robert R.
The Companies Acts 1980 and 1981:
A practitioners' manual.
London, Lloyd's of London Press [26-30 Artillery Lane, Bishopsgate, London E17LX], 1983. 313 pp.
Manual of company law as it stood on 1 April 1983 providing information based on subject matters on company law rather than numerical order of sections of the law.
(B. 105.814)

INTERNATIONAL

International

TAXATION: AN INTERNATIONAL
prespective. Proceedings of an international conference. Contributors include: James M. Buchanan, Edgar L. Feige, Sir Alan Walters, Assar Lindbeck.
Walter Block and Michael Walker (Editors).
Vancouver, The Fraser Institute [626 Bute Street, Vancouver V6E 3M1], 1984. 447 pp., $ 14.95.
This book contains the papers and proceedings of the Fraser Institute's International Symposium on taxation. Experts on public finance present studies of the fiscal systems of the U.S.A., U.K., Canada, Sweden, German Federal Republic, Italy, Australia, and Japan.
Heavy income tax combined with high marginal rates stimulates the hidden economy and/or the black market.
(B. 105.730)

LATIN AMERICA

Bermuda

TAX & INVESTMENT PROFILE.
Bermuda.
New York, Touche Ross International [One World Trade Center, Suite 9300, New York, NY 10048], 1984. 14 pp.
Information guide on investment and taxation aspects prepared by local office.
(B. 18.323)

Brazil

INVESTMENT IN BRAZIL.
São Paulo, Peat Marwick [Avenida Brigadeiro Faria Lima, 613-11th Floor, São Paulo, SP 01451], 1983. 105 pp.
(B. 18.328)

Panama

INVESTMENT IN PANAMA.
Panama, Peat Marwick [Avenue 4a Sur (Call 5D) No. 54, (Apartado 5307), Panama 5], 1983. 105 pp.
(B. 18.329)

PANAMANIAN CORPORATIONS.
Panama, centre of the world – heart of the Universe.
Panama, Kuzniecky & Levy [P.O.Box 5179, Panama 5], 1983. 78 pp.
Text of the Panamanian Corporate Law in English and Spanish.
(B. 18.324)

Uruguay

HEIMANN, Claudio.
El nuevo regimen impositivo del sector agropecuario.
Montevideo, Arthur Young & Co., 1984. 11 pp.
New tax system for agricultural sector.
(B. 18.325)

MIDDLE EAST

Bahrain

BAHRAIN – AN INTERNATIONAL
financial centre.

Manama, Bahrain Monetary Agency [P.O.Box 27], 1984. 82 pp.
A review of the financial structure of Bahrain described.
(B. 56.512)

Egypt

ABRAHAM, Nicholas A.
Doing business in Egypt.
Boston, Trade Ship Publishing Co. [Sixty State Street, Boston Ma., 02109], 1979. 276 pp.
(B. 56.509)

Iraq

TAX & INVESTMENT PROFILE.
Iraq.
Baghdad, Saba & Co. [P.O. Box 2319 Alawiya, Baghdad, Iraq], 1984. 36 pp.
Information guide on investment and taxation aspects prepared by local office.
(B. 56.511)

Oman

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Oman.
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(B. 56.510)

Saudi Arabia

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Riyadh, Ministry of Finance and National Economy, 1984. 7 pp.
(B. 56.513)

NORTH AMERICA

Canada

McKIE, A.B.; ROBERTSON, R.; WILSON, James R.
Foreign tax credits and foreign affiliates.
Toronto, Butterworths, 1984. 163 pp., £ 26,60.
Monograph dealing with the foreign tax credit system and the taxation of foreign source income arising from foreign affiliates or trusts under Canadian tax law.
(B. 105.776)

PIPES, Sally; WALKER, Michael; WILLS, Douglas.
Tax Facts 4.
The Canadian Consumer Tax Index and you.
Vancouver, The Fraser Institute [address see above], 1984. 187 pp., $ 4.95.
Study to find out how much tax, in all forms, Canadians pay to federal, provincial, and municipal governments and how the size of this tax bill has changed from 1961 to the present.
(B. 105.747)

United States

AMERICAN FEDERAL TAX REPORTS.
Second Series. Vol. 53.
Englewood Cliffs, Prentice-Hall Inc., 1984. 1397 pp.
Bound volume containing unabridged Federal and State Court decisions arising under the federal tax laws (previously reported in Prentice-Hall Federal Taxes) on income tax, estate and gift tax and excise tax.
(B. 105.743)

CASES AND MATERIALS ON income taxation of multi-jurisdictional corporations.
Selected by C. Douglas Miller.
Supplement to Federal Limitations on State and Local Taxation.
Leyden, University of Leyden, 1984. 72 pp.
Compilation of important income tax documents on multinationals for graduate students of tax law of University of Leyden.
(B. 105.753)

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Das Recht der U.S. partnership und limited partnership einschliesslich ihrer Besteuerung.
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Loose-Leaf Services

Received between 1 December and 31 December 1984

Australia

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- Current taxation
  releases 37-42
- Cases
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Butterworths, Pty., Ltd., Chatswood.

Belgium

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Ministère des Finances, Brussels.

COMMENTAAR OP HET WETBOEK VAN DE INKOMSTENBELASTING

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Ministère des Finances, Brussels.

FISCALE DOCUMENTATIE VANDEWINCKELE

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CED-Samsom, Brussels.

GUIDE PRATIQUE DE FISCALITE

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CED-Samsom, Brussels.

Canada

CANADA INCOME TAX GUIDE REPORTS

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CCH Canadian Ltd., Don Mills.

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Report Bulletin
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Common Market (EEC)

HANDBOEK VOOR DE EUROPESE GEMEENSCHAP

- Verdragsteksten en aanverwante stukken
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France

DICTIONNAIRE PERMANENT – DROIT DES AFFAIRES

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Editions Législatives et Administratives, Paris.

JURIS CLASSEUR – DROIT FISCAL – CODE GENERAL DES IMPÔTS

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Editions Techniques, Paris.

German Federal Republic

HANDBUCH DER BAUHERRENGEMEINSCHAFTEN UND GESCHLOSSENEN IMMOBILIENFONDS

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Peter Deubner Verlag, Cologne.

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release 23, 24
Herman Luchterhand Verlag, Neuwied.

STEUERERLASSE IN KARTEIFORM

release 279
Verlag Dr. Otto Schmidt, Cologne.

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release 395
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UMSATZSTEUERGESETZ (MEHRWERSTEUER)

Hartmann – Metzenmacher
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Erich Schmidt Verlag, Bielefeld.

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release 45
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The Netherlands

BELASTINGWETGEVING:

- Inkomstenbelasting 1964
  releases 123, 124
- Loonbelasting 1964
  release 95
- Omzetbelasting 1968 (BTW)/1978
  release 34

Noorduijn, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING:

- Gemeentelijke Belastingen e.a.
  release 80

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FED LOSBLADIG FISCAAL WEEKBLAD

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S. Gouda Smit Quint – D. Brouwer, Arnhem.

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STAAT- EN ADMINISTRATIEFRECHTELIJKE WETTEN

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Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE:

- Algemeen deel
  release 125
- Inkomstenbelasting 1964
  releases 443-448
- Loonbelasting 1964
  release 310-312
- Successiewet 1956
  release 100
- Vennootschapsbelasting 1969
  release 126, 127

Kluwer, Deventer.

Norway

SKATTE-NYTT

A, releases 11, 12
B, releases 30, 33, 34
Norsk Skattebetalerforening, Oslo.

United Kingdom

SIMON'S TAX CASES

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Butterworth & Co., London.

SIMON'S TAXES

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Butterworth & Co., London.

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Butterworth & Co., London.

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Prentice-Hall, Inc., Englewood Cliffs.

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releases 9-12
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE REPORTS

releases 10, 11
Commerce Clearing House, Inc., Chicago.

FEDERAL TAX TREATIES – REPORT BULLETIN

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Prentice-Hall, Inc., Englewood Cliffs.

STATE TAX GUIDE

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Commerce Clearing House, Inc., Chicago.

TAX IDEAS – REPORT BULLETIN

releases 23, 24
Prentice-Hall, Inc., Englewood Cliffs.

TAX TREATIES

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Commerce Clearing House, Chicago.

Conference Diary

MARCH 1985

Euroforum: Recent developments in international tax law considered from the Dutch point of view (Seminar) (including: the *Antilles-route*, tax treaties with the U.S.A., Canada and other important countries; tax consequences of the transfer of head offices). Amsterdam (Netherlands), 5 March (Dutch).

Zentrum für Unternehmungsführung: Fourth International Symposium China '85 (including: the new economic laws, taxation in China, the special economic zones). Regensdorf-Zürich (Switzerland), 5 and 6 March (English).

Kluwer Seminars: International Tax Treaties (including: U.S. approach of anti-abuse provisions in tax treaties; Netherlands approach to the use of tax treaties; change of the tax statute for the Kingdom of the Netherlands on international tax planning; the Netherlands Antilles-American tax treaty). London (United Kingdom), 7 March (English).

ITPA: Zürich/Liechtenstein Seminar (including: the place of Switzerland in international tax planning; an overview). Zürich (Switzerland), 7-8 March (English).

City Business Conferences Limited: Current options (including: accounting and taxation). London (United Kingdom), 15 March (English).

European Study Conference: International Tax and Acquisition Strategy for the 80's and Beyond (Seminar), Amsterdam (Netherlands), 18-19 March (English).

Business Research International: Disclosure to the tax authorities at home and abroad (plus 4 workshops) (including special update: U.S./Netherlands Antilles tax treaty). Amsterdam (Netherlands), 20-21 March (English).

Management Centre Europe: Managing and developing foreign subsidiaries (including: tax in international operations). Brussels (Belgium), 25-27 March (English).

British Branch of I.F.A.: Customs planning and transfer pricing (including customs, excise, VAT and corporation tax (S. 485) aspects and valuation (Tax workshop). London (United Kingdom) 27 March (English).

Seminar Services International: Doing business in Japan (including: taxation of foreign companies). Düsseldorf (German Federal Republic), 28 and 29 March (English).

APRIL 1985

Management Centre Europe: International Business Tax Conference (including: current opportunities and pitfalls in tax planning; the OECD view of transfer pricing and the U.K. approach to international taxation; foreign tax credit planning; tax efficiency treasury/cash management). Brussels (Belgium), 10-12 April (English).

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: Intercantonal tax law (Seminar). St. Gallen (Switzerland) 15-18 April (German).

British Branch of I.F.A.: Recent United Kingdom and United States tax cases. London (United Kingdom), 23 April (English).

JULY 1985

Hartford Institute on Insurance Taxation: Second Annual International conference on Insurance Taxation. Montreux (Switzerland), 1-3 July (English).

World Peace Through Law Center: The Tax Panel discusses: Taxation, National cooperation encourages international trade. Berlin (West), 21-26 July (English, French, Spanish, German).

SEPTEMBER 1985

39th Annual Congress of I.F.A.: I. The assessment and collection of tax from non-residents. II. International double taxation of inheritances and gifts. London (United Kingdom), 8-13 September (English, French, German, Spanish).

OCTOBER 1985

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: International tax law and tax planning (Seminar). St. Gallen (Switzerland) 21-24 October (German).

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 Research International, 57/61 Mortimer Street, London, W1N 7TD, United Kingdom.

City Business Conferences Limited, 41 Ladbroke Grove, London W11 3 AR, United Kingdom.

Euroforum, Piazza 401, 5611 AG, Eindhoven, Netherlands.

European Study Conferences Limited, 177 Avenue A. Huysmans, Bte 9, B-1050 Brussels, Belgium.

Hartford Institute on Insurance Taxation, Avon Commons, 49 West Main Street, P.O. Box 845, Avon, Connecticut 06001 U.S.A.

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

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ITPA, 33a Warwick Square, London SW1V 2AD, United Kingdom.

Kluwer Seminars, 565 Fulham Road, London SW 6 1ES, United Kingdom.

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Seminar Services International, Boulevard de Pérolles 7a, CH-1700 Fribourg, Switzerland.

World Peace Through Law Center, 1000 Connecticut Avenue, NW, Washington DC 20036, U.S.A.

Zentrum für Unternehmungsführung, Schulstrasse 7, CH-8802 Kilchberg ZH, Switzerland.

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Die Umsatzsteuer in Paraguay ist eine der in Entwicklungsländern selten erhobenen Einzelhandelssteuern; es könnte für andere Entwicklungsländer, die auch keine Umsatzsteuern erheben, interessant sein, diese Steuer als Alternative zur Mehrwertsteuer oder Umsatzsteuer auf der Stufe der Hersteller ins Auge zu fassen.

Guenter Schindler und David Henderson:

USA: Konzerninterne Verrechnungspreise – Untersuchung der Rolle einer funktional-bestimmten Gewinnaufteilung *108*

Trotz der anhaltenden Ungewissheit, von der Entscheidungen zu den konzerninternen Verrechnungspreisen umhüllt sind, zog der IRS im April 1984 die Schlussfolgerung, dass keine Notwendigkeit bestünde, die gegenwärtige Haltung der Behörde zur – ziemlich undeutlichen – Section 482 IRC zu ändern. Diese Studie von Schindler Associates begründet dagegen die

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Notwendigkeit, eine "Funktionsanalyse" zu entwickeln, die als alternativer Rahmen den Gesellschaften dazu dienen könnte, ihre internationale Steuerplanung mit einem höheren Mass an Sicherheit durchzuführen.

A.B.C. Emmanuel:

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Patricia Dunn:

Foreign Sales Corporations (FSCs) – Ein Überblick über mögliche Standorte – 117
Durch entsprechende Gesetzgebung der USA wurde mit Wirkung ab Januar 1985 ein neues Rechtsgebilde geschaffen, die Foreign Sales Corporation (FSC). Im Wettlauf darum, ihr Staatsgebiet für die Ansiedlung von FSCs attraktiv zu machen, haben die in Frage kommenden Länder und US-Besitzungen Gesetze erlassen, die bestimmte steuerliche Vergünstigungen für dort errichtete FSC vorsehen. Dieser Artikel analysiert und vergleicht die FSC-Gesetzgebung von verschiedenen der möglichen Standorte.

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pas nécessaire de modifier son attitude (bien que celle-ci ne soit pas très nette) quant à la Section 482. Cette étude faite par Schindler Associates analyse, par contre, le besoin de développer l'analyse fonctionnelle, une autre structure qui aiderait les sociétés à développer leur gestion fiscale internationale avec une plus grande assurance.

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PARAGUAY:

The Retail Sales Tax
(Impuesto a las Ventas)

By Melissa H. Birch and John F. Due

Ms. Birch is Assistant Professor of Business Administration, Colgate-Darden Graduate School of Business Administration, University of Virginia.

John F. Due is Professor of Economics, University of Illinois, Urbana-Champaign.

This article is based on information obtained by Professor Birch in Paraguay in the Fall of 1984. The authors are greatly indebted to officials of Paraguay, Dirección de Impuesto a la Renta for their assistance, and to various persons in the business community of Asunción who were interviewed.

The retail sales tax and the value added tax through the retail level are now universally regarded as the optimal forms of sales tax from the standpoints of avoidance of economic distortions and attainment of desired patterns of distribution of burden. The least developed countries of the world, however, do not regard these two forms as feasible from the standpoint of administration and compliance, and thus impose the tax either at the import and manufacturing level, or, particularly in ex-French countries, as a value added tax extending through the manufacturing and larger wholesaler sectors. But countries from the lower-middle income group (using the World Bank classification) upward have been moving to the use of taxes extending through the retail level, typically of the value added form. The industrialized countries can apply the tax to or through all retailing; the middle-development countries must exclude smaller retailers (and other small establishments), applying the tax up through sales to these firms.

The choice by these countries between the value added tax and the retail sales tax, in both instances excluding smaller retailers, is not always a clear cut one. This general issue has been discussed extensively in the literature, and will only be summarized here. The retail sales tax is in a sense simpler and easier to understand, involves substantially less paper work for vendors and the tax administration, and avoids the task of refunding amounts of tax collected on various transactions and then subject to rebate (particularly on exports). The value added tax, on the other hand, is collected in large part at importation and on sale by manufacturers, small in number and relatively easy to control; if evasion occurs at the retail level, much of the tax has already been collected on the commodities. Furthermore, it provides an audit trail, since tax reported as paid by one firm to another on purchases should appear as tax paid by the second firm to the Government.

Most of the middle-level countries have opted for the value added tax; it is now the standard levy in Latin America, including Mexico. But a few have opted for the retail level, applying the tax to sales by larger retailers who are registered for the tax, and on the sale by wholesalers or other suppliers to unregistered retailers and other unregistered purchasers. The first country to use this tax was Honduras,[1] which ultimately moved to the value added tax. Zimbabwe uses a similar tax.[2] Of the industrial countries, the tax in Switzerland is somewhat similar, but it is regarded basically as a wholesale tax, with optional registration by retailers.[3] When Paraguay introduced a sales tax in December 1968 (Law No. 69), the retail form, with exclusion of smaller retailers, was adopted, primarily because it was simple, and appeared to be easy to administer. The tax replaced a group of excises. The basic structure has remained unchanged; there were rate changes in 1973 (Law No. 415), and in January in 1983 (Law No. 1035) a wide range of services was added, a practice more common in Latin America than in other parts of the world.

Paraguay, with a mid-1982 population of 3.1 million, has an estimated per capita GNP (1982) of $1,610 dollars. It is primarily an agricultural country, with limited industry but a well-organized commercial sector.

REVENUE IMPORTANCE OF THE SALES TAX

The tax yields between 5 and 7% of the total central Government revenue, as shown in Table 1. The excises yield roughly twice as much revenue. Customs duties, social security levies and the corporate income tax are the other major sources, as shown in Table 2. There is no general personal income tax in operation; an income tax law is on the books but has not been implemented.

The sales tax yield as a percentage of total tax revenue is relatively low compared to that in other countries. For sales tax using countries in South America in the same per capita income range as Paraguay the average yield of the sales tax as a percentage of total tax revenue is 18; world-wide the figure is 14.

THE BASIC STRUCTURE OF THE TAX

In general, the tax applies to sales by registered firms, whether manufacturers, wholesalers or retailers, and to specified service establishments. The law makes no distinction between wholesale and retail sales; all firms with annual sales in excess of 8.4 million guaranies (at the official 1984 exchange rate, $52,500) must register and collect tax. The sales figure was 4.2 million guaranies prior to January 1984 and remains at this figure for registered service establishments. Sales between registered firms are exempt from tax. Thus manufacturers can buy materials and parts free of tax; sales by manufacturers and importers to registered wholesalers are free of tax, as are sales by these firms to those retailers that are registered, namely, the larger firms. The tax

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[1] John F. Due, "The Retail Sales Tax in Honduras", *Interamerican Economic Affairs*, Vol. 20 (Winter 1966) pp. 55-67.

[2] "The Experience of Zimbabwe with a Retail Sales Tax", *Bulletin for International Fiscal Documentation*, Vol. 37 (Feb. 1983), pp. 51-58.

[3] John F. Due, "The Swiss Wholesale Sales Tax and its Significance for Proposed Changes in the Canadian Federal Sales Tax", in *Commodity Tax Symposium*, Canadian Institute of Chartered Accounts, Toronto, 1981.

Table 1
Paraguay, sales tax yield, 1979-1983

Year	Sales tax revenue (in guaranies)	% of tax revenues	% of GDP
1979	2,881,467,526	7.1	0.67
1980	3,524,257,243	7.3	0.63
1981	3,750,326,170	6.9	0.53
1982	3,607,871,189	5.7	0.49
1983	2,926,790,528	4.9	

Sources: Finance Ministry, Banco Central del Paraguay *Boletin Estadistico* and *Cuentas Nacionales* for the respective years.

Table 2
Percentage of total tax revenue from major sources
Paraguay, 1978-1981

	Income taxes			Indirect taxes							
Year	Personal	Corporate	Total	Customs	Excises	Sales tax	Total	Export duties	Social security	Property	Other
1978	0.4	11.2	14.6	17.0	13.5	5.8	37.8	0.9	13.5	7.1	26.1
1979	0.3	11.8	14.6	18.2	12.8	6.1	38.2	0.8	13.4	6.8	26.2
1980	0.0	15.8	16.6	16.8	11.5	6.2	35.6	0.7	14.4	6.6	26.1
1981	0.0	17.0	17.8	14.7	10.8	5.7	32.2	0.5	16.1	9.0	24.4

Source: International Monetary Fund, *Government Finance Statistics Yearbook,* 1979-1982.
These figures do not coincide exactly with those in Table 1 as they are taken from a different source.

rate is the same whether the sale is made at wholesale or at retail, unlike the Swiss practice, which applies a lower rate to retail sales.

Tax applies at importation by non-registered purchasers, and to use by firms of goods purchased or imported tax free. Registered firms can import free of tax material used in the production of another (taxable) article.

There are currently about 3,000 registered firms, estimated to include only about 3% of all firms in the country, but with an estimated 75% of total sales volume. No distinction is made in the listing of registrants between wholesalers and retailers.

COVERAGE

Tax applies to sales of all commodities except those specifically exempt, and to the rendering of specified categories of services.

Exemptions

There are a number of commodity exemptions, which differ somewhat for imported and domestic goods and are provided for several different reasons.

Imported and domestic:
Medicines
Salt, baby formulas, fruits from Argentina
Seed, fertilizer, pesticides, barbed wire
Machinery, equipment, tools and parts for industrial and agricultural activities
Petroleum products (subject to excises)
Books, magazines, newspapers, school supplies
Breeding animals

Domestic products, a much broader list:
Food, including candy, ice cream, ice, water
Soap, matches
Firewood, charcoal
Electricity
Blankets, ponchos
Building materials
Tobacco, cigarettes, alcoholic beverages, cigars (goods subject to excises)
Livestock feed, fungicides, livestock
Unprocessed agricultural, livestock, and forest products
Handicraft products

Imported only:
Medical, dental, and veterinary equipment and supplies.

Thus there are three primary categories, in terms of objectives:

1. Items regarded as basic necessities, some of which, such as a portion of unprocessed food, do not pass through regular wholesale or retail channels.
2. Major inputs for agriculture, and capital equipment for industry and agriculture.
3. Commodities subject to excises.

The coverage, however, is relatively broad. Sales to the central government, government agencies and firms, and municipalities are subject to tax.

Services

The tax had not applied to services until 1 January 1984, when a substantial range was subjected to tax. These are enumerated, whereas the tax applies to all commodities except those specifically exempted. The services can be grouped into several categories:

Hotel, motel and related charges
Rental of equipment and machinery, except for use in agriculture, fishing, and forestry
Parking charges
Rental of furniture and tableware
Rental of vehicles, aircraft
Professional services, including work of consultants, accountants, technical, and the like
Banking and financial charges; insurance commissions
Real estate brokers
Photocopying and photography
Advertising
Movie theaters, theatrical events, conferences, exhibitions

Because the tax on services is new, details of its operation have not been fully worked out. In general, services rendered to registered firms are not taxable.

MEASURE OF THE TAX

The tax applies to the selling price on usual commercial transactions. Charges for interest (but not transport) are excluded so long as they are invoiced separately. Value of returned merchandise and deposits, such as on bottles, are deductible. On credit sales, tax applies to the cash price. Tax applies when the sale is made, not when the payment is received. On imports by non-registered firms tax applies to the observed market price, or to the cost plus 30%; the same rule applies when goods are given away or sold at a discount.

RATE STRUCTURE

The rate structure differs from most present-day sales taxes in that imported goods are taxed more heavily than domestic goods, thus adding to tariff protection. As of 1984, the rate structure is as follows:

Taxable domestic goods and taxable services: 4%.

Imported goods (rates apply at importation or domestic sale of imported goods):

Basic: 8%
Reduced: 5%, on buses, taxis, trucks, and railroad freight cars
"Luxury": 14%:
cameras, photographic equipment
clocks and watches
jewelry, precious stones, articles of gold and silver
porcelain, crystal
furs
furniture, doors, windows, venetian blinds, carpets
many electrical appliances and articles, such as air conditioners, electric shavers, refrigerators and freezers for home use; clothes washers and dryers, refrigerators, toasters, beaters, vacuum cleaners, floor polishers
radios, television sets, record players, tape recorders, records, tapes, amplifiers
yachts, sail boats, outboard motors and boats
stoves, oven space heaters, water heaters
cosmetics, perfumes
silk, nylon, and dacron fabrics
automobiles, small trucks
toys and games

The 4% basic rate is a relatively low rate by comparison with sales taxes of other countries. The list of commodities subject to the higher sales tax rate is typical of that of most countries using more than one rate; the higher rate concentrates primarily on consumer durables.

Prior to 1 January 1984, the respective rates were 3, 5 and 8 instead of 4, 8 and 14%.

About 60% of the tax revenue is collected at importation.

ADMINISTRATION

The tax is administered by the Sales Tax Unit of the Dirección de Impuesto a la Renta, the income tax administration, except for the portion at importation, which is collected by the Customs Administration. Thus administration is coordinated with that of income tax, following the common Latin American pattern, in contrast to the usual British Commonwealth policy of assigning sales taxes to Customs and Excise. There are about 250 professional employees involved in administration of the sales tax, the majority (about 70%) with training in accounting, 10% in law, 20% in economics and business administration. Some have university degrees; all have had course work in the respective subjects. The employees have civil service status. Training programs are provided, as well as scholarships for study in other countries.

Salaries are regarded as relatively low, but they are legally supplemented by sharing in fines imposed; the employees receive 30% of the fines from infractions they discover.

There are five regional offices (in Ciudad Presidente Stroessner, Pedro Juan Caballero, Villarica, Col. Ovieda, and Encarnación) with three or four officials assigned to each office. These regional offices oversee the administration of the tax in their area and receive monthly returns, but they do not conduct audits.

OPERATION OF THE TAX

Registration

Firms with annual sales (taxable and exempt) in excess of 8.4 million guaranies, as noted, must register, as well as all importers and all corporations regardless of sales volume. New firms must register when their annual sales reach 2.1 million guaranies (US$13,125). A form for registration is provided, requiring information on location, capital and sales. The forms are obtained from the tax offices, for a nominal sum. Firms subject to registration but failing to register are subject to fine when discovered.

Once a firm is registered, it must remain registered unless its sales fall below 8.4 million guaranies for two consecutive years. Firms quitting business must notify the tax office or be subjected to assessment for tax.

A registration certificate, with a number, is issued; when the firm buys for resale it must indicate its registration number to its supplier, and show the number on all its invoices. Registration certificates must be renewed annually.

Returns

Copies of the return form are supplied by the tax administration. There are separate sections for sales of commodities and services. Information is required on total sales, exempt commodity sales, export sales, sales to other registered firms, plus information on goods manufactured and imports during the month, and specific information on automobile sales. The returns call for far more detail than is usually required on sales tax returns.

Returns are required on a monthly basis, to be filed by the 15th of the following month. Returns must be accompanied by payment, by check or bank draft. Returns and payment may be filed by mail but most are hand delivered. The master file and returns data are on computer tape.

If a return is not filed, or found to be inaccurate, the administration will estimate the sales and tax on the basis of past sales, purchases, inventories, operating expenses, and investment expenditures and assess the tax. Penalty for failure to file can be up to 25% of the tax due, with a minimum of 500 guaranies. Interest of 1% a month is applied to delinquent accounts. If return is not filed and payment made within three months after the due date, a notice is sent demanding immediate payment; if payment is still not forthcoming, the administration will resort to the courts and typically obtain a lien on the property. While figures are not available of the number not filing on time, about 2% of the accounts go to legal action. In 1983, a total of 5,222 sales and income tax returns reached legal action, but it is estimated that only 5% of these were sales tax returns. Failure to file and pay is typically the result of economic difficulties in a particular sector; firms simply are short of funds. In 1983, the recession caused difficulties for many firms.

AUDIT

The administration operates a substantial audit program, with sales and income tax audit integrated. Audit is performed by joint audit committees, with representatives from sales, income, property, and customs units. Committees are based in Asunción and travel about the country to audit the firms. About 90% of the audits reveal errors in reporting of tax. The registered firms, which are required to issue invoices on all sales, must keep invoices for a five-year period; the invoices must clearly distinguish between exempt and taxable sales, and sales at the various rates. Invoices on sales to registered firms must indicate the purchaser's name, address, and registration number. When the auditor discovers an error, he may seize and impound records showing the error; he may make an assessment of additional tax and penalties, but may not collect them. Payments must be made to the tax administration office.

Penalties for failure to conform with the law but not involving fraud, including failure to file a return or to provide adequate documentation, or impeding an audit may be as great as 25% of the tax due, with a minimum of 500 guaranies (about $2). The penalty for evasion may be as much as 50% of the tax, and one of 100 to 200% of the tax evaded can be applied in cases of fraud. Penalty is reduced if the payment is made within 5 days of the citation.

Audit coverage is only about 700 accounts annually, though the aim is to audit 60%. Even with the limited coverage, the revenue gained from audit is above 10% of the total sales tax revenues.

Cost of administration is about 1% of revenue.

ATTITUDES TOWARD THE TAX

The general impression in Paraguay is that the tax operates relatively effectively, and despite the low rate is productive of substantial revenue. Complications are obviously caused by the use of more than one rate on imported goods. Since the tax applies at a uniform rate regardless of the type of business, it avoids the complications found in the Swiss wholesale tax of distinguishing between wholesale and retail sales. Liability depends on the size of the business; the rate is the same whether the seller is a wholesaler or retailer. Unlike the Swiss system, retailers have no possible incentive to register; since the tax rate on retail sales, on prices including the retail margin, is the same as on wholesale sales. If anything, the tax discriminates against the larger retailers. But there appears to be little complaint; other advantages of large scale retailing appear to be so great that these firms express little concern about competition of smaller firms that are not registered, and there is some sympathy in government and elsewhere for the small retailer. No tendency is reported for firms to split into several smaller ones to escape the requirement to register. The delineation line is sufficiently low that the tax in fact is basically a retail sales tax rather than a wholesale tax.

Three complaints are raised in business circles against the tax in Paraguay. First the tax is charged with being inflationary, raising prices and thus contributing to the wage-price spiral. The tax is not separately quoted from the prices, as is the practice in the United States and Canada. If it were separated, the effects of the taxes on prices might be regarded to a lesser extent as an "inflationary" change. Secondly, it is argued that the tax is one more factor encouraging smuggling into the country. Smuggling is a very major problem; one international agency report suggests that not more than 50% of all import transactions pass through legal channels. The primary causes are the high import duties and the requirement of substantial foreign exchange deposits; the sales tax may contribute to the problem but could scarcely be the major cause. If the commodities pass through the hands of registered firms after they are smuggled in, the sales tax still applies, assuming the registered firms pay tax on the goods. Thus the effect of the tax is on direct smuggling by the consumers, and by small non-registered sellers.

Finally, it is argued in the country that the sales tax provides one more incentive to operate business "outside the law" – escaping into the underground economy to avoid all taxes and other restrictions. In Paraguay there are widespread reports of evasion of taxes – reports impossible to verify.

None of the complaints are related to the particular form of the sales tax used.

CONSIDERATION OF POSSIBLE CHANGE TO A VALUE ADDED TAX

Consideration has been given to shift to a value added tax, now the standard form of sales tax throughout most of Latin America. With a given rate and coverage, the yield would be the same as well as the final distribution of burden. The prime advantage of the value added tax would be the collection of a substantial portion of the tax at importation and manufacturing, lessening the danger of evasion (so long as smuggling can be prevented) and also in providing an audit trail. But the value added tax would involve more paper work for both business firms and the administration. Over time it is likely that more attention will be given to the value added tax, but there does not appear to be any immediate urgency for change. Apparently one objection to shifting to value added is that it is believed that this would require implementation of the income tax law, and this is opposed by many persons.

CONCLUSION

The tax appears to work reasonably well, with very little complaint about discrimination or economic distortions, despite the fact that the tax favors small retailers over larger registered ones. While ultimate shift to the value added tax would probably increase effectiveness of operation and lessen evasion, there appears to be no urgent need for change. The extension of the tax to services has obvious merit, although some services are likely to be difficult to reach effectively. The one feature of the tax that can be seriously questioned is the application of a higher rate of tax to imported than domestic goods. This complicates the operation of the tax, likely results in many errors of application, and confuses the picture of actual protection provided domestic industry. There is strong merit in providing protection only by customs duty measures, not by other taxes as well. The three rates could be applied equally well to domestic and imported goods; but using more than one rate undoubtedly complicates the application of the tax.

INTERCORPORATE TRANSFER PRICING

The Role of the Functionally Determined Profit Split Explored

By Guenter Schindler, Ph.D. and David Henderson

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INTRODUCTION

Intercorporate transfer pricing is one of the most complex areas of international taxation. The tax treatment of transactions between related parties, U.S. and foreign, is shrouded in uncertainty. Section 482 of the Internal Revenue Code grants the IRS vast authority to allocate income from U.S.-controlled foreign operations to their domestic parent, or to U.S. operations of foreign corporations, when income results from transactions between related entities. The guidelines under the Internal Revenue Regulations interpreting IRC 482 are complex to some, confusing to many, and inadequate to others.

Results of litigaton in this area have only compounded the uncertainty that corporations face. As a result, the Treasury has been called upon to expand the rules. By drawing on various proposals for reform, this article sheds new light on the merits of including the funtionally determined profit split in the Regulations.

SECTION 482 AND THE REGULATIONS

The history of Section 482 is as long as the Section is short.[1]

> 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 or his delegate 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 such organization, trade or business.

Part of the tax laws since 1921, Section 482 is a mere 94 words long but has given rise to more tax disputes and more tax revenues than any other section of the Revenue Code. Section 482 is multi-faceted in that it addresses several policy issues at one: tax avoidance, assignment of income, general deduction theories, and notions about clear and proper reflection of income.

Regulations interpreting Section 482 were introduced in 1968. At that time, observers noted that the "New Regulations would amplify the principles of the Revenue Code and should diminish the struggle, by giving guidance as to the manner in which corporations carry out transactions with their affiliates, with reasonable confidence that IRS audit of these transactions would not result in increased liabilities under Section 482".[2] In the eyes of some experts in this field today, the Regulations are considered to be easier to administer and should not be changed.[3] Whereas in the opinion of others they are artificial, vague, difficult to administer, and ripe for reform.[4] Despite these Regulations, uncertainties in the area of intercorporate transfer pricing continue to trouble corporations, tax administrators and the courts alike.

A 1972 study sponsored by the Conference Board and developed by Michael G. Duerr offered the first comprehensive review of the 1968 guidelines. The study drew upon some 500 U.S. corporations' experiences with Section 482. The foreword by Alexander Trowbridge, then President of the Conference Board, is as applicable today as it was in 1972.

> This study focuses on an obscure but highly controversial area of tax administration – Section 482 of the Internal Revenue Code. Decisions arising out of this Section have cost some companies many millions of dollars and threaten to have a similar impact on others.[5]

From a corporation's point of view, intercorporate transfer pricing must respond to various corporate

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[1] General Accounting Office, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations*, September 1981, p.2. Section 482 had its origins in Section 240(d) of the Revenue Act of 1921, which authorized the Commissioner of the IRS to "consolidate the accounts" of related trades and businesses for the purposes of making accurate distribution or apportionment of gains, profits, income, deductions or capital between or among related trades or businesses. The Senate Finance Committee believed that Section 240(d) was necessary to prevent the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized to conduct business in foreign countries. In the Revenue Act of 1928, Section 240(d) was changed to Section 45 and subsequently became Section 482 during the 1954 revisions to the IRC. No substantive changes were made to the law either in 1928 or in 1954.

[2] Harry Mansfield: *Journal of Taxation*, January 1968.

[3] Stuart R. Singer, 13th Annual Institute on International Taxation, August 1982; Robert K. Decelles and Johan R. Raedel, *Journal of Taxation*, January 1980.

[4] Stuart R. Singer, 13th Annual Institute on International Taxation, August 1982;
Jane O. Burns, *Journal of Taxation*, May 1980;
General Accounting Office, Ibid;
James P. Fuller, *Journal of Taxation*, January 1980.

[5] Michael G. Duerr, *Tax Allocations and International Business: Corporate Experience with Section 482 of the Internal Revenue Code*, (New York: The Conference Board, 1972), p. iii.

management objectives, in addition to potential tax consequences. However, the IRS may view intercorporate transfer pricing as purely tax-motivated.

The guidelines under the Regulations provide four different methods for placing related taxpayers on a tax parity with uncontrolled parties:

- the comparable uncontrolled price method;[6]
- the resale price method;[7]
- the cost-plus method;[8]
- "any other reasonable method."[9]

It is a requirement of the Regulations under the priority of application rule that these methods be applied in the above-listed order. The first three methods are predicated on the "arm's length" standard. The fourth method is not well defined under the Regulations. Stanley Surrey, at that time Undersecretary of the Treasury, said that: "awareness exists of the narrow focus of the three comparable pricing methods. To the extent feasible we [Treasury] will make the fourth method broader in its application and clarify its relation to the other three approaches". To date, however, no further clarifications have been developed.

THE ARM'S LENGTH STANDARD

The rules under Section 482 are based on the premise that a subsidiary, or a controlled entity, is economically as well as legally separate from its parent corporation. In reality, however, though corporations are composed of many legally separated entities, intercorporate pricing decisions are often made as if the corporate group were one economic entity. This difference in approach has created many of the tax problems in this area.

The arm's length standard, upon which the first three methods are based, states that the transactions and costs of related parties must be compared with transactions of uncontrolled parties in the open market place. This standard was expected to solve intercorporate transfer pricing problems. However, repeated pricing disputes and considerable litigation with the IRS have shattered this expectation.

The major shortcoming with the first three methods is the difficulty of finding potentially comparable transactions for comparison purposes. Rarely, if ever, are transactions with unrelated parties comparable to those between related parties. Although arm's length transactions may appear similar, they are often economically different in the underlying facts and circumstances. Sufficient information is often lacking for meaningful comparisons.

A second difficulty in applying the first three methods is the pricing adjustments necessary to account for differences between transactions. These adjustment factors (described under Regulations 1.482-2(4)(2)(ii)) involve difficult determinations of whether or not, and to what extent, differences exist. The Regulations then require that any differences be isolated and quantified to permit appropriate pricing adjustments before arriving at a viable price comparison.

Differences that may affect the transfer price are those of quantity, quality, terms of the sale, and the level of the market in which the sale takes place. While some of the differences are measurable, others are not[10]. The entire adjustment process involves subjective judgment. This same subjectivity is employed to determine a definite dollar amount that reflects as closely as possible the price observations found in the market place.

In presentations before that *13th Annual Institute on International Taxation*[11], Stuart R. Singer addressed the difficulty of applying the adjustment factors: "The Regulations set up an "artificial standard" to determine whether (comparability) is given, and if so, whether significant adjustments are needed to make it serve. The absence of a mechanical, or at least ready, method of pricing the adjustment factors leaves the adjustments themselves to become the subject of considerable dispute".

Singer feels that the examples given in the Regulations are almost simplistic in that they assume these differences to be easily quantifiable. An attempt to determine the value of "control" illustrates the problem he raises. Two major court cases, DuPont[12] and U.S.

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[6] The comparable uncontrolled price (CUP) is the price charged to or by an unrelated firm, and may be obtained from readings of transactions involving the parties under examination, or involving unrelated parties.

[7] The resale price method is used in the absence of dealings with unrelated parties. By subtracting an appropriate mark-up , based on market observations, from the actual sale price, a derived transfer price is established that the related supplier (manufacturer) should have charged its foreign buyer (distributor). The resale price method is the most applicable when the related buyer (distributor) does not provide substantial product formulation or further processing.

[8] The cost-plus method is an appropriate profit percentage based on observations in the market place which measures the appropriateness of the transfer pricing charged to a related party.

[9] Commerce Clearing House, Inc., *Income Tax Regulations as of March 15, 1983*, Volume Two, 1.482-2(e)(1)(iii).

[10] Richard H. Kalish, *The Tax Advisor*, April 1978. Some measurable differences in price may occur in transportation costs, insurance costs, financing costs, sales promotional or advertising costs, customs duties, etc. Some of the not so measurable differences involve the presence of intangibles (e.g., trademark), which may be present in the related but not in the unrelated sales. Also, differences in quantity or frequency of services are more difficult to quantify. Quality differences may also require differentiations in the price between related and unrelated parties. Product development and origination costs may be relevant in the case of goods that required substantial research and development, the value of which may be difficult to ascertain. The value of special credit terms, loan guarantees, and assistance in the area of product market development, either in the form of marketing know-how, or through pricing discounts for initial market penetration, may require important differentiations and adjustments for comparison to the arm's length transfer pricing. These and other economic factors may need to be taken into consideration when comparing unrelated prices to the price charged between related parties. Such adjustments might benefit from a carefully developed analysis of the different roles and functions performed by the respective entities.

Examples of economic factors that are indeed difficult to measure are the requirements for specialized electronic equipment for differences in voltage and frequency in foreign markets; warranty provisions of greater duration than those customary in the United States; and product modifications necessary to meet foreign market requirements.

[11] Stuart R. Singer, 13th Annual Institute on International Taxation, August 1982.

[12] 608 F. 2d 445 (Ct. Cl. 1979) cert. denied. DuPont had created a wholly-owned Swiss marketing subsidiary. The IRS found and the Court sustained that the division of profits of roughly 75/25 in favor of the Swiss subsidiary was economically unrealistic, given the limited functions performed by the subsidiary. DuPont argued that its pricing was in compliance with the resale price method under the Regulations 1.482-2(e)(3). The Court held that DuPont had failed to quantify the adjustment factors, hence failing to confirm substantial comparability.

Steel[13], have addressed the viability of the adjustment factors and of the comparability standard itself.

The Court's decision and related observations in the DuPont case placed the arm's length standard in serious question. The Court stated that, "in using (the Swiss subsidiary) it was made difficult, perhaps impossible, to satisfy the controlling Regulations under Section 482". The Court also added enormous weight to the burden of proof[14] by requiring DuPont to establish comparability in general and to develop the appropriate adjustments for differences between controlled and uncontrolled transactions. James P. Fuller, one of the foremost legal experts in intercorporate transfer pricing, interpreted the DuPont decision to suggest that the IRS needs to consider revising its transfer pricing rules.[15]

The U.S. Steel case also illustrates some of the problems with the arm's length standard and the requisite adjustment factors. The Tax Court decision had rejected the reliance on comparisons with transactions between unrelated parties and preferred to determine the appropriateness of the transfer pricing on some other, more reasonable, basis. The Second Circuit Court, in reversing the Tax Court decision, accepted transactions that amounted to less than 5% of the company's total business to meet the requirements for determining an arm's length price. This was then applied to determine the appropriateness of the transfer pricing between the parent corporation and its subsidiary, which involved more than 95% of the subsidiary's activities.

The lengthy and repeated litigation aside, the reaction to the final decision has been divided. Decelles and Raedel (*Journal of Taxation,* August 1980) found that "the Second Circuit decision has taken a significant step towards restoring order to the chaotic state in which the arm's length pricing standard of Section 482 was left after the Court of Claims' decision in E.I. DuPont de Nemours". The authors acknowledge the problems under the Regulations: "The U.S. Steel decision, in reversing the Tax Court, points up the shortcomings of the Section 482 regulations and highlights the need for clearer safe-harbor rules".

Most of the proposals for reform call for the Regulations to be expanded particularly as concerns the adjustment factors and how to quantify them. Some of these proposals have focused on the revision of the guidelines for implementing the fourth method.

THE FUNCTIONAL ANALYSIS

The basic issue addressed in Section 482 is how to determine which country may tax what portion of the profits earned by two or more related corporate entities dealing with one another. This determination ascertains whether or not related parties have clearly reported the income that each entity has earned through controlled transactions, without any shifting of earnings. Where the first three methods prove inadequate, the fourth method attempts to provide an alternative basis on which to establish comparability – the profit split. However, the Regulations fail to provide specific guidelines for the development of this new standard. The Internal Revenue Manual directs Revenue personnel to take a functional approach toward, and to determine the relative values of, the respective functions performed within a corporate group. The Manual states[16] that all, or virtually all, Section 482 cases can be reduced to four basic questions:

- What was done?
- What economically significant function was performed?
- Who performed each function?
- What is the economic value of each function performed by each party?

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[13] 617 F. 2d 942 (2d Cir. 1980), rev'g 36 T.C.M. 586 (1977). U.S. Steel owned Navios, a Liberian shipping corporation organized to ship iron ore produced by its Venezuelan subsidiary, Orinoco. Navios performed shipping services not only for U.S. Steel, but also for some unrelated parties, which were charged the same rates as the parent corporation. The IRS found the profits to be excessive and proposed that 25% of Navios' gross income be reallocated to U.S. Steel. The taxpayer disagreed with the allocation and the Tax Court, relying on a functional economic analysis, reduced the proposed allocation to roughly half of this amount. The Court of Appeals subsequently overturned the Tax Court's findings by confirming that the transactions with unrelated parties, totalling no more than 4% to 5% of its total business, were similar enough to support the taxpayer's shipping rates to its parent corporation, which amounted to nearly 95% of its total business. No concern was given to the differences in fact and circumstances that might reflect volume, assurance of business, or the like. The Court of Appeals, in fact, rejected the notion of considering a volume discount "because it would lead to a highly undesirable uncertainty" if accepted.

[14] The burden of proof falls totally on the taxpayer not only to prove the arbitrariness of the IRS allocation, but to demonstrate that the transactions, following appropriate adjustments, were indeed comparable under the terms of the Regulations. Whenever a taxpayer sues for a refund, the burden of proof includes the determination of the amount of the refund claimed. Even if litigating in the Tax Court, the Court may make an approximate allocation when little evidence exists as to its amount. These approximate allocations may be difficult to upset on appeal, which means that the taxpayer will lose his case in whole or in part, if he fails to demonstrate the proper allocation even though the Court may disagree with the Service's allocation. As Jane Burns points out, even this process is clouded by uncertainty: Is it the method used, the results, or both which must be proven to be arbitrary, unreasonable or capricious? Facing litigation under these conditions – with the burden of proof on the taxpayer – has been a strong inducement for settlement.

[15] Both the U.S. Steel and the Dupont cases demonstrate the troublesome nature of the Regulations' dependence on the comparability standard. The requirement to develop appropriate adjustments for comparing third party transactions with related party transactions compounds the burden of proof on the taxpayer.

Many intercorporate transactions are not duplicated in the open market place, or, if they do exist, not enough information may be readily available for use in establishing transfer pricing, or for consideration during tax audit. The absence of uncontrolled transactions creates special problems, because the Regulations offer no specific guidance in that situation. Unique business relationships further complicate, and at times preclude, the use of the arm's length standard. The absence of arm's length comparisons makes that standard under the Regulations useless. The real problem is, of course, that almost by definition the business relation between a parent and its subsidiary corporation is unique.

Furthermore, certain intercorporate transactions digress from arrangements which would have been made between unrelated parties, due to national policy considerations that may override the market place. The production and sale of natural resources may be subject to greater than normal taxation to assure the country of origin an appropriate share of the international profits associated with that resource. Also, the presence of foreign currency restrictions may affect the taxation within a certain country to actually affect transfer pricing within that country, but only in that country. See *Journal of Taxation,* January 1980.

[16] Internal Revenue Manual 4233, chapter 500, 523.2-523.4.

These questions do not easily elicit satisfactory answers. This approach requires an economic study and analysis that is normally outside of the expertise and knowledge of corporate tax executvies. It goes beyond tax motives and allows for consideration of the economic factors underlying the transactions. The effectiveness of this approach hinges on understanding the economic functions performed by each party. The functional analysis is a careful review of the entire corporate operation, based on a working knowledge of both the industry at large and the particular corporation under examination. It offers a solution for transfer pricing questions that cannot be resolved by the arm's length standard.

The functional analysis permits due consideration of each corporate member's involvement in terms of capital, skill, and exposure to risk. Functions that give rise to profits are performed by individuals: sales, engineering and accounting services, for example. Other economically significant functions are performed by capital (machines) and by intangibles, such as the know-how for using the machines or for the sale of the product.

The best source of information for the functional analysis is the corporation itself: the corporation's financial statement. It covers the structure of the corporate group: name, location, principal affiliates, percentage of ownership, geographic areas of operation, operating results and sales in these aras, as well as sales by major product lines. Other extremely important sources of information are interviews with the staff of both the parent corporation and the field facilities. These interviews should be with executives and operating personnel alike. An on-site visit to the field facility is often invaluable for an accurate assessment of what economic functions are actually performed. The functional analysis is critically important to the establishment of the alternative standard of comparability – the profit split.

A profit split does not allocate income and expenses, but rather measures the reasonableness of the reported profit distribution. James P. Fuller (52 *Journal of Taxation* 10) presents a strong endorsement for the specific inclusion of the functionally determined profit split in the Regulations.

> Profits are the real issue in [transfer-pricing] cases, and should be treated as such. Profit split pricing and profit split pricing analysis have gained a measure of acceptance in the courts. In order to be realistic, all determinations should be in accordance with the income-producing functions performed by the related companies. Thus, if a comparable uncontrolled transaction is available it should be used; but in the absence thereof, a functional approach would be appropriate, since it would show profits in line with those reasonably to be expected between unrelated parties.

The absence of any useful rules-of-thumb for determining an acceptable division of profits is a problem to which several proposals for reform are addressed.

Several transfer pricing cases in litigation have been resolved by the court's reliance on a profit split. *PPG Industries*[17], for instance, successfully demonstrated to the Court that it was receiving "a fair share of the profits". In the *Lufkin Foundry* case[18], the Tax Court accepted a profit split approach where about 52% of the combined profit was allocated to the parent, and 48% to its foreign subsidiary. In both the *Lufkin* and *PPG Industries* cases, the Courts' decisions were based on sophisticated analysis submitted in support of the respective profit splits. However, the *Lufkin* case was subsequently reconsidered by the Fifth Circuit Court, which reversed the Tax Court's profit split on the grounds that "no quantum of evidence as to a taxpayer's internal transactions with its own subsidiaries, standing alone, can be sufficient to establish arm's length dealings between them".[19] The comparisons presented had been based on dealings with other related entities. Therefore, rather than establishing precedents to help in enforcing the rules, these cases have added to the confusion and uncertainty faced by taxpayers under the strict comparability standard endorsed by the Regulations.

NEED FOR REFORM

Experts on Section 482 are widely divided on the use of the comparability standards. In their review of the *DuPont* case (*Journal of Taxation,* August 1980), Decelles and Raedel observed that "since it has been virtually impossible to apply the (arm's length) comparability standard, the case had to be evaluated under the "nebulous and undefined" fourth method". Stuart R. Singer also acknowledged the difficulty in implementing the rules under Regulations 1.482-2(e)(2)(ii) (13th Annual Institute on International Taxation): "The Courts have had trouble dealing with comparables and frequently have fallen back on the profit split as a handy, if simplistic, method". Singer continued, "the easy availability of the fourth method may well have undercut the use of the comparability standard". Despite his desire to restrict the use of the fourth method, Singer feels that if a particular fourth method is to be accepted, it should become part of the Regulations.

Occasional reviews of the IRS enforcement experiences under Section 482 have not resolved the controversy over the adequacy of the rules as they stand under the Regulations. In *Cadillac Textiles*[20], the IRS argued that Section 482 regulations were not applicable and that there was an uneven profit split. The taxpayer demonstrated that its intercorporate transfer pricing had been based on the rules under the Regulations. The Court, however, decided in favor of the IRS.

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[17] 55 Tax Court 928, 1970. PPG Industries, Inc., a U.S. manufacturer of glass, fiberglass, chemicals and paint had formed a Swiss subsidiary to handle its export activities, including sales to two large Canadian subsidiaries, which had previously been supplied directly by PPG. The Service attempted to reallocate all of the profits on sales to the Canadian subsidiaries and to allow the Swiss subsidiary only a 2% profit on other sales. PPG introduced evidence to demonstrate that the profit split between the two related companies was reasonable (about 55% U.S., 45% foreign). The court found the profit split reasonable and upheld the taxpayer's pricing.

[18] 30 T.C.M. 400, 1971.

[19] 468 F.2d 805 (5th Circuit 1972), Lufkin Industries.

[20] 34 T.C.M. 295, 1975.

A recently concluded study by the IRS found that the comparability standard remains a viable tool for resolving transfer pricing issues.[21] However, independently developed surveys have confirmed that many transfer pricing cases are not resolved by using the comparability standards prescribed by the Regulations.[22] The most recent survey by the General Accounting Office concludes that 87% of the tax dollars assessed in transfer pricing situations have been assessed on other than the arm's length standard.[23]

As the Treasury Department pointed out, there is room for argument over the appropriateness of the statistical bases used by the GAO. The evidence presented, however, offers little assurance concerning the adequacy of the comparability standard under the Regulations.

The GAO report echoes all other surveys by calling on the Treasury to "review the experience with transfer pricing issues and to give clearer guidance through a revision of the Regulations".[24]

James P. Fuller believes that factors might be sought that would approximate the division of profits produced by the market place. If so, the arm's length and profit split approaches become similar in theory and goal, though they reach that goal by different routes.

The most drastic departure from the strict adherence to the comparability standard is contained in a proposal currently being drafted by the American Bar Association's Taxation Committee.

> Transfer pricing regulations in their present form are deficient in three ways, with the result that uncertainty is created for the taxpayer's planning. First, the methods prescribed by the Regulations are for the purposes of determining "the" arm's length price rather than a range of acceptable prices. Second, the methodology for establishing the arm's length price under the Regulations is so complex that it is difficult and excessively burdensome for the taxpayer to establish prices in conformity therewith. Third, the authority of the IRS is so broad and involves such subjective judgment that a taxpayer cannot be assured that its transfer pricing will be accepted on audit.[25]

The ABA proposal calls for deleting the priority-of-application rule under the arm's length standard. It specifically recommends that:

> 1) a reasonable price established by a taxpayer in a controlled sale of tangible property be deemed to be an arm's length price; and
> 2) establishment of a reasonable price by the taxpayer under any reasonable method for determining a reasonable price in a controlled sale of tangible property be treated as an equally acceptable method of determining an arm's length price as the comparable uncontrolled price, the resale price and the cost-plus methods, as modified, without any priority among these alternative methods.[26]

The recommendation defines a reasonable price method to mean:

> Any method calculated to yield a reasonable price taking into account all relevant facts and circumstances including the profit margins of the buyer and seller; the relative costs of producing and selling the goods; the terms and timing of the sale; the risks assumed; the functions performed and the value added by the buyer and the seller; and the market conditions related to the transaction. The above list of factors is not intended to be an exclusive list of the factors to be taken into account in making a determination of a reasonable price".[27]

A more recent call for reform of the rules under Section 482 comes from Norman B. Ture, former Under Secretary of the Treasury for Tax and Economic Affairs. In a memorandum to Secretary Regan proposing a solution to unitary tax issues, Ture states: "The present 482 regulations are conceptually inane in terms of the rudimentary economics of transfer pricing. Even worse, they are the source of great uncertainty concerning the ultimate tax liability of corporate taxpayers". Ture continues to advise that the Treasury promptly begin to develop new regulations that would offer practicable, sensible transfer pricing and income allocation rules under Section 482. He suggests that Treasury economists should take primary responsibility for formulating income allocation and transfer pricing rules that reflect good economics and sound business practices.

SUMMARY

The recent increase in American business interests abroad and the increasing presence of foreign operations in the United States give new urgency to implementation of the proposals for expanded guidelines. The functional analysis has successfully been used to establish a proper evaluation of profits earned, based on a reliable interpretation of the economic factors influencing the controlled transactions. While retaining the comparability standard as a primary approach to income allocation issues, the inclusion of precise wording in the Regulations for developing a functionally determined profit split would give corporations a clearer understanding of the parameters for transfer pricing. Such an addition to the Regulations would also resolve many of the enforcement problems that tax administrators face concerning income allocations under Section 482.

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21. Department of the Treasury, Internal Revenue Service, *IRS Examination Data Reveal an Effective Administration of Section 482 Regulations,* Report prepared by the Assistant Commissioner (Examination), (Washington: Treasury, April 1984).
22. Five significant surveys have reviewed the IRS enforcement experience under Section 482:
Michael G. Duerr, *Tax Allocations and International Business.* The Conference Board, 1972;
Department of the Treasury News Release, January 8, 1973;
Jane O. Burns, "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey". *Journal of Taxation,* May 1980;
General Accounting Office, *IRS Could Better Protect U.S. Tax Interest in Determining the Income of Multinational Corporations,* September 1981;
Department of the Treasury, Internal Revenue Service, *IRS Examination Data Reveal an Effective Administration of Section 482 Regulations,* Report prepared by the Assistant Commissioner (Examinations), April 1984.
23. General Accounting Office. Op.cit., p. v.
24. Ibid., p. vii.
25. American Bar Association, Committee on Affiliated and Related Corporations and Committee on Foreign Activities of U.S. Taxpayers, Draft Proposal, January 28, 1983, pp. 7-8.
26. Ibid., pp. 2-3.
27. Ibid., p. 18.

ZAMBIA:

Advantages Offered to Foreign Investment

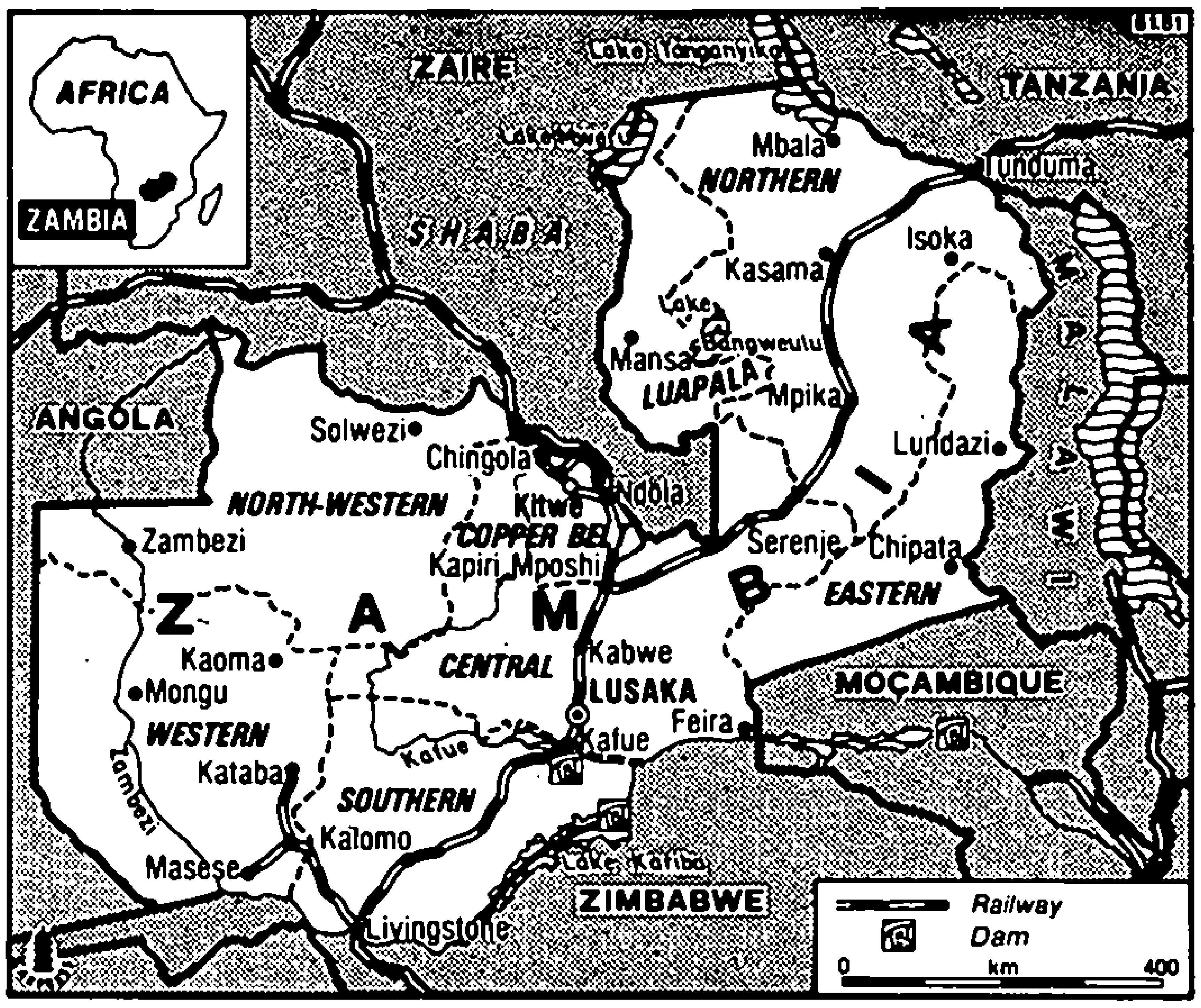
By A.B.C. Emmanuel

Humanism in Zambia is a political philosophy which endeavors to devise a social, political and economic order which will create an egalitarian society and the avoidance of exploitation of man by man. To achieve this, after many years of colonial rule, the State has stepped in to control and guide the industrial, agricultural and other economic activities of the country with the ultimate goal of the creation of a socialist economy. More than 80% of the industrial and other activity of the country is controlled by the Zambia Industrial and Mining Company (ZIMCO) which is wholly owned by the Government of the Republic of Zambia. With an annual turnover of about 1,000,000,000 kwacha and with its 120 subsidiary and associate companies, it is not only the major force in the national economy but also ranks high among the great companies of the world.

Under the umbrella of ZIMCO are associated companies and subsidiaries (called Parastatals) which are divided into the following categories: (a) Mining, which is the most important sector of the Zambian economy and accounts for about 90% of the country's foreign exchange (the giant mining companies of R.C.M. and N.C.C.M. have merged into Z.C.C.M. (Zambia Consolidated Copper Mines) which is the second largest copper mining group in the world – there are also coal, and other metal mines in this group); (b) manufacturing; (c) trading; (d) finance; (e) energy; (f) transport; (g) hotels; (h) agriculture and rural development; (i) post and tele-communications; (j) others – which include the Zambia National Building Society.

The incorporation of ZIMCO was in March 1970, subsequent to the economic reforms announced by His Excellency the President, Dr. Kenneth Kaunda. The objective of the reforms was to ensure that the nation acquired control of the vital sectors of the economy and also to make readily available the facilities for the acquisition of skills and technology pertaining to economic development.

Against this background, one wonders what role the private sector plays or could play in the economy of Zambia. Private enterprise is not discouraged but, on the contrary, has of late been encouraged. Foreign capital is welcomed provided it is made available without strings and provided it does not go against the principles of humanism. Zambia's economy is a mixed economy. The growth of ZIMCO shows that the State can participate in industry and commerce on a business-like profit-making basis and also that the State can work in harmony with the private sector.



Incentives – the industrial sector

The Pioneer Industries (Relief from Income Tax) Act was introduced in 1965 with a view to encouraging the establishment and development of new industrial and commercial enterprises in Zambia. It was found that the incentives given under this Act were insufficient for the growth of private enterprise and it has been superseded by the Industrial Development Act of 1977.

The objects of this Act were to *"provide for the licensing and control of manufacturing enterprises; to provide incentives for investment; to regulate the making of contracts relating to the transfer of foreign technology and expertise to enterprises operating in Zambia; and to provide for matters connected with or incidental to the foregoing".*

Incentives for priority enterprises

Many incentives with regard to income tax, customs duties and sales tax are granted. In addition, rebates in tariffs and preferential treatment with respect to the granting of and the processing of import licenses are offered for a "priority enterprise" as defined in this Act.

The Minister of Commerce and Trade may grant "priority enterprise" status to an enterprise if he feels that two of the criteria described in paragraphs (d) (e) and (f) have been satisfied. The following are the criteria by which an enterprise may be classified as a priority enterprise:

(a) maximum utilization of domestic raw materials;
(b) production of intermediate goods which are used by other industries;
(c) diversification of its industrial structure;
(d) creation of substantial opportunites for permanent employment;
(e) improvement of domestic industrial skills or fostering the development of domestic technology;
(f) promoting industrial development in rural areas.

The following incentives are given to priority enterprises:
(1) preferential treatment with respect to Government purchasing, unless the tender price submitted by such enterprise exceeds the lowest bid by 10%;
(2) preferential treatment with respect to the granting and processing of import licenses;
(3) rebates on customs duties payable on capital equipment, raw materials and other intermediate goods if;
  (a) in the case of capital equipment, labor-intensive techniques of production are not a viable alternative;
  (b) in the case of raw materials, such materials are not available from domestic sources of supply;
  (c) in the case of intermediate goods, such goods do not inhibit the creation of domestic value-added;
(4) relief from sales tax in respect of items described in paragraph (3) subject to the provisions of this paragraph;
(5) relief from selective employment tax for such period as the Minister responsible for the administration thereof may prescribe;
(6) relief from income tax in such manner and for such period as the Minister responsible for the administration thereof may prescribe.

In consequence, the Minister of Finance by Statutory Instrument No. 106 of 1981 has declared that a priority enterprise shall be exempt from all taxes payable under the Income Tax Act and the Selective Employment Tax Act for:
(a) a period of 5 years; or
(b) such longer period as may be approved in respect of any particular priority enterprise.

Further, where a priority enterprise incurs capital expenditure during the tax relief period on assets which continue to be used in the same enterprise after the expiry of the tax relief period, such capital expenditure will, for tax purposes, be deemed to have been incurred on the day next following the end of the tax relief period.

As far as losses are concerned, where a priority enterprise has incurred losses during its tax relief period which remain uncleared at the end of such period, such losses will, for tax purposes, be deemed to have been incurred on the day next following the end of the tax relief period. Losses under the Income Tax Act can be carried forward till they are extinguished.

Incentives for priority and non-priority enterprises

Any enterprise which provides training facilities or incurs training expenses for Zambian citizens will be entitled to write off against income tax any such expenses or expenses incurred in the provision of such facilities.

The following incentives will apply to any enterprise which utilizes investment provided from outside Zambia or which, in the opinion of the Minister, employs within Zambia a significant amount of foreign capital:
(a) a right to remit, on cessation of a business interest, the value of such foreign capital or such investment, subject to the law relating to exchange control at the time of application for remittance;
(b) on making application thereof, an election to remit any accrued profits or dividends during the 12-month period immediately following the end of the financial year to which the application refers, subject to any law relating to exchange control at the time of such application;
(c) any remittable profit which is reinvested in Zambia shall be credited to any amount which may be remitted on the cessation of a business;
(d) immunity from nationalization unless the highest considerations of public interest so require.

Agricultural sector

With the sharp fall in the price of copper and thereby the revenue and foreign exchange earned, great importance has been attached to the agricultural sector. Land is the "property of the State" and under the Land (Conversion of Titles) Act of 1975, "all land in Zambia vests absolutely in the President who holds it on behalf of the people of Zambia". The State grants leases for 100 years which can be renewed for further periods of 100 years subject to certain conditions laid down in the Act. There are Government-owned farms, very large private farms owned by commercial farmers who are mostly Zambian citizens of foreign origin and small holdings.

Incentives

With a view to encouraging agriculture the following incentives have been offered:
(1) Companies carrying on farming activities will be taxed at a flat rate of 15% only, whereas the rate of tax on income from all other sources is 50%.
(2) Individuals who receive income from farming will be taxed at the normal rates for individuals but the maximum rate will be 15% only, whereas the highest rate of tax for income from other sources is 80% on a graduated scale.
(3) Expatriate (non-Zambian) farmers are allowed to remit overseas 12.5% of their annual profits provided certain conditions laid down by the Bank of Zambia have been fulfilled.
(4) Farmers are given a bonus of a foreign remittance of US$ 0.63 on each extra 90 kg. bag above 5,000 bags of maize, 2,000 bags of wheat and 1,000 bags of soya beans delivered to marketing organizations.
(5) A "development allowance" of 10% of the total expenditure incurred in a charge year by a grower for planting cash crops such as tea, bananas and citrus fruits. This allowance can be carried forward for 3 years and in the case of a new grower it can be carried forward up to the first year of production.
(6) Farming machinery, equipment and implements will be depreciated at 50% per annum on the cost of an asset on a straight-line basis.[1]

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[1] Incentives Nos. 1,2,5 and 6 are provided under the Income Tax Act. Incentives Nos. 3 and 4 are under the provisions of the Exchange Control Act and come as Directives from the Bank of Zambia.

All these incentives are in addition to the normal written down allowance of 100% on the full cost of "farm works" which includes expenditure on clearing the land, stumping works in soil erosion, boreholes for water conservation, etc. and "farm improvements" which includes any permanent work, farm dwellings and other construction in connection with farming.

"Farming" according to the definition in the Income Tax Act "means any husbandry, pastoral, poultry, fish rearing or agricultural activity and includes the letting of property for any such purpose".

Incentives for Research and Development and Export Oriented Enterprises

Although these are proposed in the Industrial Development Act, they have not been given legal status either in the Income Tax or Customs Acts.

However, in accordance with the proposals in the 1984 Budget, the Honourable Minister of Finance has passed legislation to the effect that the maximum rate of tax on that portion of the income which is determined by the Commissioner of Taxes as originating from the export of "non-tradition products" will be 15%. "Non-traditional products" are defined as anything produced or manufactured in the Republic other than electricity and includes semi-precious and precious minerals if the same are exported through the Reserved Mineral Corporation Limited. This excludes mining which is the chief and main source of revenue.

Similarly although there are incentives offered to enterprises which provide training facilities or incur training expenses for Zambian citizens to set off such expenses against Income Tax, no legal status has yet been given in the Income Tax Acts.

However, under the 1981 amendment to the Selective Employment Tax Act there is provision for the Commissioner of Taxes to allow as a deduction from the amount of the tax charged under S.E.T. Act any expenditure incurred in the training of Zambian employees to acquire professional qualifications in the profession of the employer. This relief is applicable for employees in the following professions: accountancy, architecture, civil, mechanical and electrical engineering and quantity surveying.

In practice relief will be given only after the employee (a) has successfully completed the full examination, (b) is permanently employed by the employer. If, for example, Mr. A commences training in 1981/82 and successfully completes in 1985/86 and becomes permanently employed immediately thereafter and if the expenditure has been as follows:

1981/82	-Kawacha	(K)	1,500
1982/83	-	K	1,500
1983/84	-	K	2,500
1984/85	-	K	4,000
1985/86	-	K	2,000
		K	11,500

If the S.E.T. payable on expatriate employees total K 12,000 in 1985/86, this sum of K 11,500 can be set off in 1985/86 against K 12,000.[2]

Restrictions on the repatriation or remittance of profits

Some problems arise when profits are to be remitted out of Zambia.

Due to the drastic drop in the price of copper, the main earner of foreign exchange, Zambia has experienced very severe exchange problems since 1974. There is considerable delay in the repatriation of capital and the remittance of profits which must be paid into the "pipeline".[3]

This "pipeline" is a suspense account in the commercial banks wherein are held all payments due to foreign exporters who supply to Zambia. The account also includes debts for services, royalties, loans, dividends, profits, and other sundry items such as personal remittances of expatriate employees. The kwacha equivalent of all payments held in the pipeline is in turn deposited by the commercial banks with the Bank of Zambia.

As foreign exchange becomes available for the purpose, the Bank of Zambia allocates funds to the commercial banks. These funds are applied to the pipeline accounts in the commercial banks on a "first in first out" basis.

The present arrears in the pipeline range from about 12 to 30 months depending on the category of the debt. The arrears are about 20 months for import payments and about 30 months for profit and dividend remittances. Education and medical needs are given top priority. The Zambian importer bears the risk in the event of changes in exchange rates. The Bank of Zambia permits interest to be paid on debts in the pipeline at 2% above the bank rate in the country of destination of the funds.

In view of the above there are certain conditions that have to be fulfilled when an application is made to the Bank of Zambia for the repatriation of capital and remittance of profits:

(a) Foreign investments, loans, etc. must be registered with the Bank of Zambia to ensure repatriation rights.

(b) All technology agreements must be registered with the Bank of Zambia in addition to registering with the Ministry of Commerce and Trade to ensure remittance of fees and royalties.

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[2] The Selective Employment Tax is a surcharge of 20% on the gross emoluments of every expatriate member of staff levied on the employer. This is not an allowable deduction from the income of the employer. The idea is to discourage the employment of non-Zambians and thereby encourage Zambianisation.

As far as agriculture is concerned, expatriate agricultural workers are exempted from S.E.T.

[3] The Exchange Control Act – C.A.P. 593 came into operation as from 1 June 1966.

Broadly the Act "confers powers and imposes duties and restrictions in relation to gold, currency, securities, exchange transactions, payments of debts and the import and export transfer or settlement of property and for purposes connected with aforesaid matters".

Based on the powers conferred, the Minister of Finance authorises the Bank of Zambia to administer the Act by the issuance of regulations and instructions to commercial banks. There have been and are amendments to the Exchange Control Act accordingly.

Section 31 and its subsections deal with "blocked accounts". It is under the provisions of these that the "pipeline" has been created.

(c) Profits may be remitted to foreign shareholders in the form of dividends on which a withholding tax of 20% in levied. This rate of tax may be restricted if there is a double tax agreement with the country concerned according to conditions therein. The maximum remittable dividend is the lower of 15% of the fully paid-up share capital or 50% of the after-tax profits.[4]
(d) Any capital increase must obtain prior approval of the Bank of Zambia to whom the company applies through the respective commercial bank. Branches of foreign companies are allowed to remit 50% of their after-tax profits.[4]
(e) Foreign capital can be repatriated to its country of origin provided it has been registered with the Bank of Zambia at the time it was brought to the country. It is not clear whether the share capital created by the capitalization of reserves can be taken out of the country, but it does broaden the base for profit remittance in the form of dividend.
(f) Royalties, interest, management and consultant fees can be remitted outside Zambia subject to a withholding tax of 30% of the gross amount. The withholding tax may be reduced by the double tax agreements concluded by Zambia.
(g) All royalty, management and consultant agreements must be registered with the Bank of Zambia and approval obtained as a prior condition to remittance rights. These agreements are scrutinized both by the Bank of Zambia and the Ministry of Trade and Commerce before approval is granted.
(h) All expatriate employees on a 2 or more year contract are entitled to remit overseas one third of their gross salary subject to a maximum of 600 kwacha ($ 682) per month.[5]
(i) Any gratuity at the end of the contract can also be remitted. There is no delay in the monthly remittance, but gratuities are currently held up in the pipeline for nearly 18 months.

It may, however, be mentioned that the Government is doing everything possible within its means to expedite the payments thereby reducing the delay in the pipeline, which at the moment stands at about 600,000,000 kwacha.

The Government has announced alternatives which companies with monies in the pipeline can opt for. Foreign claimants in the pipeline would be entitled to take payment of their claims in kwacha and invest the proceeds in Zambia in the form of equity in companies incorporated in Zambia. They would thereafter cease to hold pipeline claims on the amount of kwacha withdrawn from the pipeline.

Investments in Zambia of money withdrawn from the pipeline would count as new foreign direct investment for exchange control purposes.

The repatriation in foreign currency of dividends on the investment and of the principal sum invested would be subjected to the exchange control regulations in force.

Foreign claimants in the pipeline would also be entitled to take payment of their claims in kwacha and lend the proceeds in Zambia at interest thereby ceasing to hold pipeline claims. But these loans would not qualify for expatriation of interest or principal in foreign currency.

Companies coulds also use export proceeds to clear pipeline claims. Where a company exports goods from Zambia other then minerals it has the right to claim 50% of its foreign exchange earnings from the Bank of Zambia. At present, this foreign currency may only be used to pay for goods imported under valid import licenses. Henceforth the excess of the 50% over the value of the imports can be used to clear the pipeline.

Zambia has received her latest IMF loan and the Government hopes to clear a fair portion of the pipeline. The Government had hoped to make every effort to meet current payments from 1 January 1984, but unfortunately this has not materialized. The Government also hopes to obtain a further loan of 40,000,000 kwacha to lend to export-oriented companies on a revolving basis with a view to bolstering the export capability of such companies.

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[4] The percentage for the repatriation of dividends, profits etc. is under the Exchange Control Regulations.

[5] The remittance of expatriate employees' monthly earnings and end of contract gratuities are under the provisions of the Exchange Control Regulations. The monthly remittance of expatriate employees has been raised to K 833 per month (K 10,000 p.a.).

Foreign Sales Corporations (FSC)

A Survey of Selected Locations

By Patricia Dunn

This comment was written by **Patricia Dunn J.D.**, managing editor of the *Bulletin for International Fiscal Documentation*, with the assistance of the staff of the International Bureau of Fiscal Documentation.

Federal legislation replacing Domestic International Sales Corporation (DISC) regulations[1] by export incentives involving a new entity, the Foreign Sales Corporation (FSC),[2] came into force on 1 January 1985. DISC had been primarily a paper United States company which afforded a method of tax deferral on a portion of income derived from exports. Indefinite deferral was possible so long as the DISC satisfied certain qualification requirements and did not distribute deferred income to its shareholders. From its inception in 1971, DISC drew criticism from GATT as an illegal export subsidy.[3] In response to these international objections, legislation was enacted to replace the controversial DISC with the FSC.[4]

The new FSC legislation exempts about 15% of taxable income from qualified export transactions (about 16% for individuals) so long as the FSC maintains an office in a qualified foreign country or a U.S. possession (but not Puerto Rico) and has some substance outside the U.S. (TRA Sec. 801). One of the primary questions facing corporate managers, therefore, during the transition from DISC and the implementation of FSC is where to organize and operate the new FSC.

By law, an FSC is limited to one of the four U.S. possessions, a country that has signed a Caribbean Basin Initiative (CBI) agreement, or a country that has a bilateral income tax treaty with the U.S. provided the Secretary of Treasury certifies that the exchange of information program of such a country is adequate for purposes of FSC provisions.[5]

Many factors should be taken into consideration in determining where an FSC should locate, not the least of which are the tax advantages or disadvantages of the various permissible locations.[6] Generally, an FSC should be formed and operated in locations which impose no, or only nominal, income tax on its operations. Additionally, the selected location should have sufficient infrastructure to support the foreign activities of the operation.[7]

To minimize or, preferably, entirely exempt, the tax burden on an FSC, operating out of one of the common tax havens (Bahamas, Caymans, etc.) would be of strong interest to most FSCs. However, to date, only Barbados (see Caribbean, below) has signed an appropriate exchange of information agreement with the U.S., thus making it a favorably site for FSCs.

THE UNITED STATES POSSESSIONS

The U.S. possessions have been considered the most favorable locations for FSCs as they are prohibited from imposing an income tax on FSCs until 1987.[8] Additionally, in order to remain competitive with their neighbors, the U.S. possessions are offering additional tax incentives in the scramble to attract FSCs.

United States Virgin Islands

The income tax law in the United States Virgin Islands (USVI) is a "mirror code" of the U.S. federal Internal Revenue Code. FSC regulations in the USVI, therefore, mirror FSC regulations in the U.S.A. except where the special rules of the USVI's new FSC legislation (enacted 18 September 1984) apply. The USVI FSC legislation contains income tax provisions that exempt all interest, carrying charges and passive income earned by an FSC from USVI tax as well as offering a full exemption from certain USVI excise taxes, customs duty and gross receipts taxes.

On 12 December 1984, the USVI amended its FSC legislation to make it even more attractive to FSCs, primarily by repealing the 0.85% tax on Foreign Trade Income (FTI) which, under the original legislation, would have been imposed in 1987 and thereafter. The legislation, as amended, permits FSC boards to act by written consent in lieu of meetings but retains the requirement that FSCs (but not small FSCs[9]) hold an an-

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[1] Internal Revenue Code of 1954 (I.R.C.) sections 921-997.

[2] Tax Reform Act (TRA) of 1984, Pub. L. No. 98-369, 98th Congress, 2nd session. I.R.C. Act sec. 801 (adding I.R.C. sections 921-927) through 804; enacted 18 July 1984.

[3] GATT, Art. XVI(4).

[4] For an analysis of FSC provisions see *Bulletin for International Fiscal Documentation* 12 (1984) at 552.

[5] TRA § 801; I.R.C. sections 922 and 927(e)(3).

[6] In addition to U.S. possessions, 23 countries (Australia, Austria, Belgium, Canada, Denmark, Egypt, Finland, France, Germany, Iceland, Ireland, Jamaica, Korea, Malta, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, South Africa, Sweden, Trinidad and Tobago) have, to date, been certified as having adequate exchange of information clauses in tax treaties to satisfy FSC provisions. Barbados signed a CBI Agreement on 3 November 1984 thus making it acceptable. Costa Rica is expected to sign a similar agreement in the near future.

[7] To maintain tax benefits, the FSC must perform certain cost-related activities abroad (I.R.C. sec. 924(b)).

[8] I.R.C. sec. 801(a).

[9] A "small FSC" must meet the foreign presence test but not the foreign management and economic processes tests. Additionally, no more than US$ 5 million per year is eligible for FSC tax exemptions (TRA § 801; I.R.C. sec. 924(b)(2)).

nual directors' meeting with a quorum[10] physically present. An annual shareholders' meeting is likewise required but may be held by proxy.

The USVI follows the "5% rule"[11], i.e. if more than 5% of FTI of any FSC during its taxable year is derived from sales or services in the USVI, the FSC will not be eligible for the benefits of the USVI FSC law. The amended legislation exempts services provided in the USVI by a commission FSC from the 5% rule making it possible for commission income from sales activities and economic processes[12] undertaken in the USVI to benefit from USVI tax exemptions.

The USVI charges an annual FSC corporate franchise tax of US$ 400.00 for small FSCs for the first year of operations and from US$ 400 to US$ 900 thereafter, depending on foreign trade gross receipts. For other FSCs the fee is US$ 1,000 the first year and thereafter from US$ 1,000 to US$ 25,000 depending on the previous years' foreign trade gross receipts. The FSC legislation, however, provides for an employer's tax credit against the annual *franchise tax* in an amount equal to one-half the wages paid to USVI residents for services provided to the FSC, limited to not more than 50% of the FSC's franchise tax liability. The original USVI FSC legislation also provided for an employer's tax credit against USVI *income tax* liability. That credit was however repealed by the amended legislation.

Qualification for relief from corporate income tax is contingent upon the FSC's use of domestic labor and a qualified management firm. A qualified management firm is, basically, a firm which manages the FSC's USVI administrative office and which is 25% or more owned by USVI individuals. Wages paid by a management firm can be partially flowed-through to the FSC thus contributing to the direct costs that must be performed outside the U.S. (see footnote 12).

Dividends out of FTI paid to U.S. residents, citizens and corporate shareholders are exempt from withholding tax. The USVI will guarantee, in a written contract provided to the FSC, to maintain FSC benefits for at least 12 years (until 1 January 1997) provided the FSC continually complies with all laws of the Virgin Islands and pays its taxes and fees.

Its adequate communication facilities and reasonably convenient geographical area, along with the tax advantages, enhanced by the recently amended FSC legislation, has apparently made the USVI the FSC jurisdiction of choice for tax professionals. However, some corporate managers may be put off by the requirement to hold annual meetings in the USVI and regulations concerning local employees and a qualified management office.

Guam

Guam was the first U.S. possession to enact FSC legislation.[13] FSCs are exempt from all taxes on FTI, investment income[14] and carrying charges.[15] An annual license fee of US$ 1,000 is imposed (US$ 400 for small FSCs). There are no other business taxes or fees. FSC legislation applies only to FSCs incorporated in Guam.[16] The FSC must have a Guam resident manager or agent. However, Guam does not require any directors' meetings. Annual shareholders' meetings are required but may be by proxy, otherwise they must be held on Guam. Benefits are committed through 12 December 1966, approximately 12 years.

Guam views the FSC as a spring-board to open up Guam to the U.S. business community seeking to conduct business in the Pacific basin[17] and, thus, has no local office or local employment requirements. For those FSCs exporting toward the Asian market, Guam appears to be a suitable base of operations, with full banking facilities, high speed telecommunications and advanced data processing available.[18]

The legal climate is similar to that of any state in the U.S. For example, Guam has adopted the Uniform Commercial Code and the Uniform Partnership Act. Most federal statutes are applicable to Guam. The language is English; the currency is the U.S. dollar.

Commonwealth of North Mariana Islands

The Commonwealth of North Mariana Islands (CNMI) FSC statute[19] exempts FSCs from gross revenue and territorial income taxes, with no time limits. There is a requirement for an office or agent in CNMI and one CNMI resident director but no on-island meetings or other presence is required. CNMI imposes a one-time incorporation fee of US$ 100 and an annual US$ 500 license fee. Generally, the CNMI gives tax benefits only to territorial-source income. Non-CNMI-source income is taxed at the I.R.C. rate of 46% (TRA § 1002).

The CNMI has good transportation to all major Asian countries (average travel time 3-4 hours) as well as daily flights to the U.S. The CNMI enjoy good satellite communications, the U.S. Postal Service, and a full range of federal programs. Three FDIC-insured branches of U.S. banks provide banking services.

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[10] In the USVI General Corporation Code, a quorum may be fixed in the by-laws at 1/3 the total number of directors, but not less than 2 directors. Where 2 USVI resident directors constitute a quorum, it would be unnecessary for other directors to travel to the USVI.

[11] 13 Virgin Islands Code sec. 771.

[12] I.R.C. sec. 924(b) requires that certain economic processes and certain activities that generate direct costs be performed outside the U.S. by the FSC or its contracted agent.

[13] Approved 29 August 1984, amended 26 October 1984.

[14] If derived from investment of FTI or effectively connected with trade or business of an FSC.

[15] If related to or derived in connection with sale or lease of export property or otherwise effectively connected with trade or business of an FSC. Carrying charges are interest or other extra charges paid on the balance owed in installment buying. (Thus, for example, interest received by a company on installment payments for goods sold by a company to its parent, subsidiary, or to another company is, generally, taxable as income.)

[16] For incorporation and licensing requirements, see *Foreign Tax Law Biweekly Bulletin*, No. 29-30, 14 November 1984, at 17.

[17] David Santos, Tax Commissioner for Territory of Guam, as reported in 60 *Taxes International*, October 1984.

[18] Touche Ross selected countries chart in *Tax Notes*, 10 December 1984.

[19] Signed into law on 12 October 1984.

American Samoa

American Samoa, which uses the U.S. Internal Revenue Code as a territorial income tax, passed FSC legislation in October which is soon expected to be signed into law. The American Samoan legislation will exempt FSCs from income and all other taxes for 10 years. The annual incorporation fee for FSCs would be US$ 2,500 (US$ 500 for a small FSC).

CARIBBEAN ISLANDS

Jamaica

Jamaica (along with Trinidad & Tobago) is one of the Caribbean Islands that qualified under the exchange of information clause in its tax treaty with the U.S. rather than under a CBI agreement. Jamaica's FSC law[20] effectively exempts FTI and investment income and carrying charges. An annual fee of US$ 1,000 (US$ 500 for small FSCs) is imposed as well as a US$ 125 annual assets tax. Expatriate U.S. employees of a FSC will not be charged on their Section 911 excluded income, if claimed, or if double taxation exists. Work permit rules for foreign workers will not apply to FSCs.

Of special interest; FSCs need not be incorporated in Jamaica. Directors need not be resident of Jamaica nor need they be shareholders. No meetings need be held in Jamaica. Therefore, a Jamaican FSC could be administered from any jurisdiction. Finally, FSCs are exempt from exchange controls. However, there is a yearly audit for tax purposes for all companies, including FSCs, which may impose costs or administrative budgets. Additionally, FSCs must not be owned by or trade with Jamaicans.

Barbados

Barbados signed an exchange of information agreement with the U.S. on 3 November 1984 in conformance with the 1983 Caribbean Basin Initiative (CBI) Act[21], thus qualifying as a suitable location for FSCs. The Barbados Foreign Corporation Act[22] is rather attractive. An FSC is exempt from all Barbados taxes, including withholding taxes. In lieu of taxes, Barbados will charge FSCs nominal incorporation fees (US$ 500 for small FSCs; US$ 1,000 for other FSCs) renewable annually. Additionally, an FSC is exempt from exchange controls, local statutory audits and the filing of annual returns and financial statements. In order to incorporate in Barbados, the company must have, as its principal object and activity, to engage in foreign trade transactions, its shareholders must not be residents of the Caribbean Community (Caricom) and it must establish that it is designated or qualifies to be designated as an FSC. Even should a company lose its FSC status, Barbados will only tax it at a 2.5% rate as an International Business Company.[23] Temporary U.S. employees of FSCs are exempt from taxes on 35% of their income.[24] Barbados requires annual directors and shareholders' meetings but these may be conducted by telephone.[25]

Barbados is politically stable, with a two-party representative government which holds a consensus on dealing with foreign investment. A well-established business and banking sector already operates in Barbados providing services to offshore business under existing offshore legislation. Communications facilities are efficient, offering direct dialing to most of the world, including North America and Europe; reliable telecommunications, telex and facsimile transfer. The literacy rate among adults is 97%, affording efficient clerical help. The CBI exchange of information agreement with the U.S. makes Barbados available as a convention site and U.S. persons can deduct the costs of such conventions. Several convention centers are in operation which will facilitate holding conventions in conjunction with FSC meetings.

EUROPEAN TAX TREATY PARTNERS

Most U.S. tax treaty partners can be expected to impose an income tax on an FSC operating in its country. European countries, especially, have notably high levels of corporate and individual income taxation. Nevertheless, Europe is a major U.S. trading partner and operating an FSC from a European location, tax aspects aside, offers several advantages ranging from excellent communications and transport facilities to an extensive consumer market. In addition, as European countries have a large network of tax treaties, a company doing business in a European country can often ride on the host country's treaty connections.[26]

Many U.S. treaty partners are making few, or no overtures, to FSCs. France, for example, has expressed little official interest in attracting FSCs. Germany, too, is unattractive as any profits attributable to FSC trading will probably be subject to the full tax rate of 36%-56%. Other partners, particularly Belgium and the Netherlands, are actively attempting to attract FSCs to their jurisdictions, either through tax holidays or under a "cost-plus"[27] system.

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[20] Approved 6 November 1984.

[21] The Caribbean Basin Economic Recovery Act, 49 Fed. Reg. 3, 5 January 1984, Publ.L. 98-67, known as the Caribbean Basin Initiative, or CBI, is an economic recovery program for nations of the Caribbean and Central America that provides for the waiver of duties on nearly all products exported into the U.S. until 30 September 1995.

[22] Approved by Parliament on 7 December 1984.

[23] International Business Company (IBC) status requires that no business be conducted in Barbados, residents do not own over 10%, no banking and insurance business plus government aproval of IBC status.

[24] Where the Ministry of Trade is satisfied that such employees are required for the FSC to conduct its business effectively and such services are not available in Barbados.

[25] FSC regulations provide that meetings must comply with local laws. The regulations also allow meetings of directors by telephone and provide that if all directors are not physically in the same location, the location of the meeting is determined by the location of the persons exercising the majority of the voting power participating in the meeting (Temporary Treasury Regulation sec. 1.924-IT).

[26] FSC legislation prohibits an FSC from claiming benefits under a U.S. income tax treaty with any foreign country (I.R.C. sec. 927(4)(e)) but makes no mention of treaties other than those with the U.S.

[27] Under a "cost-plus" system, a foreign subsidiary's profit is deemed to be a set percentage of its operating expenses. Taxes are imposed only on that percentage.

Belgium

The Belgian approach is to allow an FSC to seek a private ruling to qualify for reduced domestic taxation in a manner similar to that provided for "coordination centers"[28], i.e. headquarters companies set up to coordinate the activities of multinational enterprises forming a group.[29] Any company formed after 24 January 1983 and incorporated in Belgium can qualify as a coordination center[30] so long as it performs one of the following functions on behalf of companies belonging to the same group: publicity, information processing, insurance and reinsurance, scientific research, national or internatial public affairs, central bookkeeping or foreign exchange exposure management and financial control.

The above functions fall within the "foreign management"[31] or "foreign economic processes"[32] required by I.R.C. regulations in order for FSCs to have FTI qualifying for tax benefits. The coordination center must, additionally, form part of a group with net assets of more than 1,000 Bfrs. million and a turnover of at least 10,000 Bfrs. million[33], a requirement some FSCs may find difficult to satisfy.

Each coordination center must, additionally, employ at least 10 full-time people within 2 years of establishment[34]. Many FSCs, too, will be too small to meet this requirement but, by grafting a small FSC onto an existing coordination center, can overcome this failing.

Coordination centers ran afoul of the EEC which objected to the 10-year tax holiday and to an exemption from social security contributions on all foreign executives or researchers including those from other EEC countries. Belgium then proposed a modified plan wherein companies incorporated outside Belgium (a branch) would be taxed on a revised "cost-plus" basis but a company incorporated in Belgium (a subsidiary) would be taxed as an ordinary corporation (45%). A subsidiary may be eligible for the "cost-plus" scheme, however, with a satisfactory showing to Belgian authorities. U.S. regulations do not require incorporation in the country of operations.[35] Further negotiations between the EEC and Belgium resulted in the Belgian parliament passing the modified coordination center bill[36] and encouraging existing coordination centers to change to the new system to avoid any further EEC action.

Even under the modified plan, coordination centers can play profitable roles in foreign exchange exposure management and financial control. According to one estimate,[37] a majority of applicants are setting up to perform some form of treasury function. It should be noted, however, that any profits of trade independent of the group are fully taxable.

Rather than coordination center status, a recent "cost-plus" ruling for FSCs in Belgium appears to offer more flexibility. A press release[38] by the Minister of Finance detailing special arrangements intended to attract FSCs stated that if an FSC takes the form of a Belgian corporation, tax will be assessed, as on all other companies, on reserved profits, rejected expenditures, directors' fees and distributed profits. However, it will be assumed that the company does not grant abnormal or exceptionally favorable benefits when the profits determined in this way do not amount to less than 8% of the costs of the following: obtaining orders, the organization of deliveries, preparation and dispatch of invoices and receipt of payment. Where a company is established as a branch of a foreign corporation, profits will be "automatically" determined at 8% of these costs; this 8% to be taxed at the effective rate of 45%. Costs of publicity, promotion, transportation of exported merchandise and the burden of credit risk will not be considered in this 8% determination. It can only be assumed that profits allocated to such costs, all of which U.S. legislation requires be borne outside the U.S.A., will be taxed at normal rates, i.e. 45%. A few days after the Minister's press release, the Head Office of Direct Taxation issued a circular[39] containing practical guidelines concerning FSCs, some apparently in contradiction to the press release. Under the guidelines, a U.S. enterprise wishing to establish an FSC in Belgium may submit an application to the Head Office of Direct Taxation for an individual arrangement. The individual arrangement would determine the profit taxable in Belgium (thus negating an automatic determination) on a flat-rate basis, which "might" be 8% of the costs or a part of the costs borne by the FSC. No flat rate need be assessed on *direct* costs of publicity and promotion, transportation of goods and assumption of credit risks,[40] according to the guidelines. Profits of 8% will be assessed on *indirect* costs, however. For purposes of the individual arrangement, income tax will not be regarded as a cost. The individual arrangement will be concluded for a 3-year period with a tacit extension (if notice of termination is not provided 6 months in advance) and lapses automatically should the FSC legislation lapse or be amended.

As they are set up by administrative rulings, no separate legislation is anticipated for FSCs. Coordination center incentives and FSC status can be granted respectively, under the Royal Decree or a variety of different laws. Since flexibility is encouraged and Belgium is anxious to attract FSCs, it appears worth approaching the Belgian authorities to apply for either coordination center or FSC status even if all the qualifying criteria cannot be met.

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[28] Special Powers Decree No. 187 of 29 December 1982; for a discussion of this decree, see 23 *European Taxation* 6 (1983) at 189.

[29] A group exists as soon as one company owns, directly or indirectly, more than 20% of another company (Decree No. 187, Art. 2(1)).

[30] Qualification by application for authorization under a Royal Decree.

[31] I.R.C. sections 924(b)(1)(A), 924(c)(1), 924(c)(2), 924(c)(3).

[32] I.R.C. sec. 924(d).

[33] Decree No. 187, Art. 3(1).

[34] Decree No. 187, Art. 4(2).

[35] I.R.C. sec. 801(a). Although not required to incorporate in the country of operations, the FSC may only incorporate in a qualified country.

[36] Law of 27 December 1984; published in Belgian Official Gazette of 29 December 1984.

[37] Reported in *Business Europe*, 25 May 1984.

[38] 23 November 1984.

[39] See *Fiskoloog Internationaal* of 15 January 1985.

[40] U.S. FSC legislation requires that a certain percentage of direct costs associated with these activities be performed outside the U.S.A. in order to maintain FSC status (I.R.C. sec. 924(d)).

The Netherlands

The Netherlands, likewise, is attempting to attract FSCs to its jurisdiction. The Dutch Finance Ministry issued tax guidelines on FSCs to local revenue officials in late November 1984,[41] only some 3 weeks after the U.S. announced its qualified country list. The flexible tax guidelines favoring U.S. companies[42] are part of a Dutch program to attract foreign investment and improve job opportunities in a time of high unemployment.

In order to qualify for reduced income taxation in the Netherlands, the FSC may engage only in administrative, preparatory, service and support functions, such as processing and acknowledging and confirming sales undertaken by U.S. exporters.[43] Although the FSC may monitor fund flows, it may not engage in any profit-generating activities such as actual selling.[44] The Netherlands, like Belgium, will use a "cost-plus" system to determine taxable profits. FSCs operating in the Netherlands will be taxed at the standard corporate rate of 43% but only on, generally, 5% of local operating costs.[45] However, this percentage may rise to a maximum of 10% if costs are low.[46] In contrast to Belgium, should the application of U.S. provisions result in the Netherlands FSC collecting greater profits than can be attributed to costs of local operations, the extra amount will not be subject to corporation tax.[47] As in many other European countries, companies are required to make an annual financial report which, in some cases, must be published. The FSC is subject to up to a 25% withholding tax on dividends distributed to shareholders but this can be reduced to as low as 5% under the Dutch-U.S. tax treaty.

Ireland

Ireland, too, is preparing tax incentives to attract FSCs to its free trade zone in Shannon. Shannon free trade zone incentives are already in place and approved by the EEC so no new legislation is needed. In addition to the obvious advantages of setting up in an English speaking, administratively friendly atmosphere, approved service companies in the free zone are entitled to the same 10% rate[48] applied to manufacturing ventures in other areas of Ireland. Since Irish authorities are willing to apportion income from the FSC back to its U.S. "permanent establishment"[49], the Irish tax rate may be as little as 2.5% to 7%, depending on how the Irish FSC's income is allocated. Ireland, additionally, will grant a unilateral exemption on dividend withholding tax to companies more than 75% foreign owned.[50]

FSC tax benefits are guaranteed to remain in effect until the year 2000. The Shannon free trade zone offers a comprehensive "set up" package for FSCs which includes 100% assistance to employee training costs, minimum procedures for establishing an FSC, a non-repayable financial Aid Package of up to 50% of the cost of buildings and plants for distribution activities and duty-free port status.[51] The Shannon area offers excellent air communications and a plentiful work force. However, the area is more rural than some may appreciate and has little business infrastructure. The personal income tax on expatriate employees is up to a high 65%.[52] To our knowledge, Ireland has no plans to reduce or exempt income taxation of FSC employees.

United Kingdom

In spite of day to day cooperation on corporate tax matters between the U.S. and the U.K., the U.K. has been excluded from the list of qualified countries. It is understood that such exclusion is largely due to the U.K.'s inability to supply information on U.K. non-resident companies.[53]

Certain companies incorporated in the U.K. exercise management and control wholly outside the U.K. and do not trade in or with the U.K. These companies become non-resident companies[54] because U.K. law defines "residence" as the place where management and control is exercised (unlike the U.S. where "residence" is defined as the place of incorporation). Apart from requiring such non-resident companies to file accounts in London, the U.K. tax authorities have nothing more to do with them. The U.S.-U.K. double taxation treaty exempts the U.K. from providing information on such non-resident companies on the grounds of lack of information.[55] FSCs could easily comply with the U.K.'s non-residence requirements[56] and thus, not be subject to the exchange-of-information provisions requisite to qualification as an acceptable jurisdiction. It is unlikely that the U.K. will change its definition of residency but it is hoped that some legislative action may be initiated in the future to gain more fiscal control over this type of company thus leading to eventual certification as an FSC qualified jurisdiction.

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The choice of an FSC location in Europe will undoubtedly be determined on a company's current corporate

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[41] See press release of the Ministry of Finance dated 28 November 1984.

[42] Strictly speaking, not U.S. companies but rather Dutch companies as Netherlands law considers companies either incorporated in the Netherlands or exercising management and control therein as resident and subject to Dutch law (General Tax Code, Art. 4; Corporate Income Tax Code, Art 2(1)(a)).

[43] Press release of the Ministry of Finance; *International Tax Report*, December 1984.

[44] Press release of the Ministry of Finance.

[45] Id.

[46] *Fiscaal Up to Date* 6 November 1984.

[47] *Fiskoloog Internationaal* 15 Janaury 1985.

[48] *International Tax Report*, December 1984, Mr. Paul McGowen, Partner, Stokes Kennedy Crowley & Co., Chartered Accountants, Dublin.

[49] Under the U.S.-Ireland Double Tax Treaty, an Irish resident company with a permanent establishment in the U.S. is entitled to a credit against Irish tax payable on its U.S. income up to a maximum of the Irish tax payable on that income (Art. III).

[50] *Business Europe*, 7 December 1984.

[51] *International Tax Report*, December 1984.

[52] *Guides to European Taxation*, Vol. III, Ireland.

[53] *Business Europe*, 7 December 1984.

[54] Determined by case law: see Simons, Corporations, esp. sec. D-108.

[55] U.S.-U.K. Tax Convention (Art. 26(1)).

[56] FSC regulations require that an FSC must be managed from outside the U.S. and provides for various activities that will constitute management. However, most of these management activities need not take place in the qualified jurisdiction where the FSC has set up.

structure in Europe and its relationships with existing trading or administrative operations more than on the tax incentives offered by qualified tax treaty partners.

None of the European countries afford the very generous tax benefits offered by the U.S. possessions. In many cases, however, the political stability and well developed technological climate of Europe will outweigh the larger tax benefits available elsewhere.

Since the new FSC regulations are modeled on other country's provisions combined with the fact that so many qualifying countries, significantly Belgium and the Netherlands, are EEC and GATT members, it is expected that any GATT objections to FSCs can be succesfully overcome thus facilitating the entry of FSCs into Europe.

CONCLUSION

The above comments are not intended as an analysis of all the possible locations from which to operate an FSC but rather as a sampling of some possibilities offered by various jurisdictions which are considering, or have already enacted, special legislation to attract FSCs. In some areas, information remains scanty, primarily due to the time constraints imposed by the announcement date of the qualified country list and the date of implementation of the FSC regulations. However, with the current high interest in the FSC and the immediacy of selecting a suitable location, new developments are reported on an almost daily basis. We expect more countries to enact tax incentives and for current regulations to be further clarified.

Gift and Inheritance Taxes in the African Continent

By Bernadette P. Davey

Contents

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INTRODUCTION

The concept of the taxation of gifts and inheritances tends to be one left over from former colonial times, particularly in those African countries which were under British colonial rule. In some cases, moves have been made to abolish this type of taxation. However, for better or worse, a number of African countries retain (at present) such taxes.

In most cases, the before-tax exemption limits ensure that the indigenous native population is not often subject to such taxes. Generally, only the richer Africans or expatriates living and working in African countries are likely to fall within the ambit of the statutes.

Altogether 11 African countries have some form of tax on the transfer of property, whether that be by way of a gift, or property passing as an inheritance. Most of these taxes are based on the former English Estate Duty and the scope of the legislation, its wording etc., are very similar among the countries imposing the levy.

One country (Swaziland) levies, in addition, a "Succession Duty" on the beneficiaries receiving property passing on death. Further countries also levy a "Transfer Duty" regardless of whether the property passes on death, by way of gift or otherwise.

Nigeria is the only country with a fully comprehensive Capital Transfer Tax covering all forms of transfer of property whether inter vivos or on death.

This survey is intended to examine, very briefly, the taxes levied in African countries on gifts and inheritances. As the provisions governing such taxes are often very similar, they will be dealt with together under the headings Estate Duty, Succession Duty, Gift or Transfer Duty and a special section dealing with Nigeria.

A. ESTATE DUTY

I. General

An estate duty is levied in Malawi, Swaziland, Tanzania, Zambia and Zimbabwe.[1] The duty is levied on the estate of all deceased persons in these countries. In Zambia and Zimbabwe, if the deceased was a resident, liability extends to his world-wide estate, with some exceptions. In other cases, the estate is usually confined to property situated in the particular country.

Generally, gifts made within a certain period before death, i.e. 2-5 years, are taken into account for the purposes of calculating estate duty.

II. Persons liable to pay the duty

The executor or the administrator of the deceased's estate is liable to pay the duty.

It may also be that the beneficiary or receipient of the property on death is liable to pay the estate duty. However, the beneficiary or recipient is generally only liable for duty up to the amount of his interest in the estate.

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[1] An estate duty is also levied in Egypt. However, this is not dealt with in the survey due to the lack of detailed information on the workings of such a tax.

III. The estate

The estate of a deceased person includes all property, whether movable or immovable, corporeal or incorporeal, situated in the country and which is owned by the deceased or deemed to be his property at the date of death.

In the case of Zambia and Zimbabwe, the movable property of the deceased situated outside the country may be included in the estate if the deceased was ordinarily resident in the country.

Property situated outside Malawi is included in the estate of a deceased person who was domiciled in Malawi.

The type of property comprising the estate is very similar from country to country and it includes the following:

(a) property taken as donation mortis causa;
(b) amounts received under insurance policies;
(c) annuities accruing to another person on the death of the deceased;
(d) any property of which the deceased was competent to dispose of at the time of death.

In Zimbabwe, donations of property exceeding Z$1,000 in value per calendar year are included in the estate unless they were given more than 5 years prior to death. In Malawi, Zambia and Tanzania donations or gifts made inter vivos within 3 years of the death are included in the estate. This may be subject in some cases to the exception of marriage gifts or charitable donations (see IV. Exemptions). In Swaziland, property exceeding a value of 200 E donated inter vivos within 2 years of the death is also included in the property comprising the estate.

IV. Exemptions

In Malawi and Swaziland very litte by way of exemptions is provided for in the legislation.

In Tanzania, Zambia and Zimbabwe, the major exemptions from estate duty include the following:

1. Tanzania

(a) immovable property situated outside Tanzania;
(b) property bequeathed to the Government;
(c) up to 2 dwelling houses which form part of the deceased's estate used by any dependant of the deceased;
(d) dispositions in consideration of marriage or for charitable purposes or up to 10,000 TShs. to any one donee.

2. Zambia

(a) estates of persons who at their death live in a communal estate in a native tribe;
(b) estates of persons dying as a result of injury, disease contracted, etc., within 3 years of death while on active service against an enemy.

3. Zimbabwe

(a) immovable property outside Zimbabwe;
(b) amounts recoverable under insurance policies by a surviving spouse or child of the deceased under a registered ante-nuptial or post-nuptial contract;
(c) foreign inheritances and foreign property acquired by donation from non-residents and retained outside Zimbabwe;
(d) foreign assets acquired by the deceased prior to 1 January 1967 and any such assets acquired before the deceased became ordinarily resident in Zimbabwe;
(e) movable assets outside Zimbabwe if the deceased is not ordinarily resident in Zimbabwe at the date of death.

V. Computation of duty

In all cases, estate duty is levied on the total value of the property comprising the estate after adjustment for allowable expenses and deductions.

The value of any property is generally the estimated price it would fetch if sold on the open market at the time of the deceased's death.

The following expenses are normally deductible:

(a) reasonable funeral expenses;
(b) debts and encumbrances;
(c) administration costs of the estate;
(d) value of any property passing to charitable or ecclesiastical institutions.

VI. Rates

The rates of estate duty vary considerably from country to country. The following are indications only of the rates applicable:

		Value of estate	*Rate*
(a)	Malawi	Up to 30,000 K	0%
		30,000 to 200,000 K	4% - 7%
		over 600,000 K	10%
(b)	Swaziland	Up to 220,000 E	0% - 33.5%
(c)	Tanzania	Up to 100,000 TShs.	3,300 TShs. + 10% of excess over 100,000 TShs.
		over 5,000,000 TShs.	2,973,300 TShs. + 80% of excess over 5 million TShs.
(d)	Zambia	30,000 – 40,000 K	4%
		40,000 – 200,000 K	5% - 7%
		over 600,000 K	10%
(e)	Zimbabwe	Z$30,000 – Z$100,000	6% - 20%

B. SUCCESSION DUTY

I. General

In Swaziland only, a succession duty is levied on recipients of property passing on death. This tax is levied in addition to estate duty.

II. Persons liable to pay the duty

The persons liable for the duty are those to whom a succession, i.e. an inheritance accrues.

III. The succession

A taxable succession is any property passing on death to the beneficiary. Property is deemed to have accrued to a beneficiary in the following cases:
(a) by virtue of dispositions made by the deceased;
(b) by reason of cessation on the death of the deceased of any interest held by him in the property;
(c) by devolution in accordance with law on the death of the deceased.

IV. Exemptions

The following recipients of inheritances are exempt from duty:
(a) a surviving spouse;
(b) the Government;
(c) a public institution in the country of a charitable, ecclesiastical or educational nature.

V. Computation of duty

The duty is levied on the value which is estimated as the open market value of the property. No deductions for expenses etc. are allowable.

VI. Rates

The rate of succession duty in Swaziland depends on the relationship existing between the successor and the deceased.

Degree of relationship of successor to deceased		*Rate of duty*
(a)	where successor is direct descendant or ascendant of deceased	3%
(b)	where successor is the brother or sister of deceased	5%
(c)	where successor is the descendant of the deceased's brother or sister	8%
(d)	where successor is otherwise related, a stranger in blood or an institution	12%

A surcharge is levied on successions, the value of which exceeds 20,000 E. The surcharge amounts to 1% of the excess over this amount.

C. GIFT OR TRANSFER DUTY

Five[2] countries in Africa (Botswana, Egypt, Ghana, Tunisia and Zambia) have some kind of gift tax, or a transfer tax which also covers gifts.

I. Botswana

A transfer duty is levied on the purchase price or value of immovable property transferred, regardless of whether it is transferred by way of sale, gift, alienated etc. The person to whom the property is transferred is liable for the duty. A number of exemptions exist including transfers to a surviving spouse, where the property was jointly owned and so on. The rates of duty range from 4% where the transferee is a Botswana citizen to 30% where the transferee is a non-citizen.

II. Egypt

In Egypt, gifts (and inheritances) are taxed, unless otherwise exempted, at a variety of rates depending on the family relationship. The rates vary between 5% on gifts up to a value of E£5,000 up to 22% if the value of the property is over E£65,000.

III. Ghana

A gift tax is levied in Ghana on inter vivos donations of buildings, land, securities and cash where the value of the property exceeds ₵ 2,000. Exemptions from the tax include gifts from parents to children, between spouses, gifts for charitable purposes and gifts to religious bodies. The rates of tax range from 5% on gifts of ₵ 2,000 to ₵ 4,000 up to a maximum of 15% on gifts of over ₵ 50,000.

IV. Lesotho

A duty is levied on the transfer of buildings or long-term leases on such buildings and on the transfer of mineral rights. A number of exemptions exist including transfers to a surviving spouse, to the Lesotho Government and to charitable or ecclesiastical institutions. The rates of duty are 3% on property valued at up to 10,000 M (Maloti) and 4% on the excess over 10,000 M.

V. Tunisia

A tax is levied in Tunisia on gains from immovable property which includes immovable property transferred by way of a gift. Exemptions include the transfer of an individual's personal dwelling. The tax is levied on the basis of the value of the property declared in the deed of gift or exchange. The rates of tax vary from 10% if the transfer is made between the 4th and 10th year of ownership up to a maximum of 30% if the transfer occurs in relation to property held for 1 year or less.

VI. Zambia

A property transfer tax is levied in Zambia on transfers by gift or otherwise of property such as land, buildings, securities etc. The rate of tax is 2.5% of the value of the property transferred.

D. CAPITAL TRANSFER TAX – NIGERIA

I. General

Nigeria levies a comprehensive tax on both lifetime donations and inheritances. This tax is levied on the transfer of all capital assets under the Capital Transfer Tax

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[2] The tax on the transfer of gifts and inheritances in Nigeria is dealt with separately here (see section D).

Act, 1979. The tax is not levied in cases of outright sale of property which may be taxable under other legislation.

II. Persons liable to pay the tax

The recipient of the property is liable to the tax on lifetime gifts and, in the case of inheritances, the executor of the estate usually pays the tax.

III. The estate or the taxable property

Taxable property which is transferred inter vivos includes all property whether movable or immovable, corporeal or incorporeal.

The estate of a deceased person is made up of all movable and immovable property, corporeal or incorporeal of which the deceased was, at the time of death, competent to dispose. Such property also incudes the following:

(a) any property taken as donatio mortis causa;
(b) any property which the deceased had transferred to himself and another person jointly so that it would accrue on his death to the other person;
(c) any annuity or other interest purchased or provided by the deceased to the extent of the beneficial interest accruing on the death of the deceased;
(d) any property passing under a settlement (not being a will) where the interest in the property is determinable by reference to death or where the deceased retained the right of absolute interest in the property.

IV. Exemptions

As regards all transfers of property, no tax is levied if the value of the property transferred does not exceed the exemption limit of ₦ 100,000.

No capital transfer tax is payable in respect of any family house, i.e. the principal private residence. Paintings, manuscripts, works of art or scientific collections donated or bequeathed to museums, universities or other public institutions are exempt from capital transfer tax.

V. Computation of tax

Capital transfer tax is levied on the value of the property being transferred. The taxable value of the property or the estate is estimated as the price it would fetch if sold on the open market at the time of transfer or time of death.

In the case of property transferred at death, reasonable funeral expenses, debts and encumbrances are deductible in the determination of the value of property for capital transfer tax purposes.

VI. Rates

The rates of capital transfer tax are as follows:

Net value of the estate or property transferred (₦)	*Rate*
first 100,000	Nil
next 150,000	10%
next 150,000	20%
next 250,000	30%
next 500,000	40%
next 1,000,000	50%
the balance	60%

CONCLUSION

This form of taxation is by no means the most significant revenue-earner in any of the countries surveyed. In some cases, the justification for a tax on property transferred is thought to be because housing and other property is in short supply. Thus, a specific tax should be directed at the property-owning among the community who often make large benefits on the sale or other transfer of property.

However, with the notable exception of Nigeria, a comprehensive transfer tax on all gifts and inheritances does not exist as such in the other countries surveyed. In some cases, for example Botswana, such a system is achieved by the levy of several separate taxes on inheritances, successions and on other transfers of property.

On the other hand, the large majority of African countries (not dealt with here) have no system of taxation in respect of gifts and inheritances. As regards its potential as a revenue-earner, it is probably not under active consideration for introduction. Time and effort might better be spent in improving the administration and effectiveness of the income tax system where far greater amounts of revenue are lost or in rationalizing the indirect taxation system to facilitate its administration and to better its enforcement.

The Cameroon 1984/1985 Budget

By Michel Lecerf, Conseil Juridique (FIDAFRICA)

The 1984/85 Finance Law for Republic of Cameroon (former United Republic of Cameroon) was enacted by Law No. 84/002 of 30 June 1984.

This law introduces modifications and alterations of the provisions of the General Tax Code and of the Registration, Stamp Duty and Trusteeship Code.

1. CORPORATE INCOME TAX

Election for corporate income tax

According to Article 2 (new) of General Tax Code, "civil companies" (sociétés civiles) may elect to be subject to corporate income tax.

Exemption of corporate income tax

Non-profit private schools are exempt from corporate income tax.

Wages and salaries considered as a deductible charge

The Finance Law modifies Article 6A of the General Tax Code. Previously, wages, salaries and compensations paid to the employees of a company were deductible only if they were not "exaggerated", i.e. did not exceed the average amount paid for a similar job in other companies. Now, wages and salaries are deductible provided they do not exceed the amounts stipulated in job agreements.

Contributions paid by the company for a pension scheme of expatriate employees are deductible if the pension scheme is compulsory. If so, the amount deductible cannot exceed 15% of basic wage of the expatriate.

2. PERSONAL INCOME TAXES

An annual tax is levied on individual incomes. This tax consists of: a "proportional tax" on specified categories of income at different rates and a "graduated surtax" on net total income. The rates of these taxes are unchanged but the brackets of the graduated surtax are increased.

The table below shows the new rates of graduated surtax applicable to 1983/84 income.

Taxable income	*Rate*
from 0 F.CFA to 500 000 F.CFA	0%
from 501 000 F.CFA to 700 000 F.CFA	10%
from 701 000 F.CFA to 1 000 000 F.CFA	15%
from 1 001 000 F.CFA to 1 500 000 F.CFA	20%
from 1 501 000 F.CFA to 2 000 000 F.CFA	25%
from 2 001 000 F.CFA to 2 750 000 F.CFA	30%
from 2 751 000 F.CFA to 3 500 000 F.CFA	35%
from 3 501 000 F.CFA to 4 500 000 F.CFA	40%
from 4 501 000 F.CFA to 5 500 000 F.CFA	45%
from 5 501 000 F.CFA to 6 500 000 F.CFA	50%
from 6 501 000 F.CFA to 7 500 000 F.CFA	55%
exceeding 7 500 000 F.CFA	60%

Income from real property is subject to the personal income taxes. The new fiscal law modifies the duration of exemption of new buildings. Now, the exemption is given for a period of 15 years (against 10 years previously). Deemed charges (fixed at the rate of 40% against 35% previously) are deductible from taxable income.

3. SALES TAX (INTERNATIONAL TURNOVER TAX)

Articles of Tax Code regarding exemption, tax deduction and tax rate are modified effective of 15 July 1984:

Tax exemption

Internal turnover tax is no longer payable on:
- interest paid by a bank to another bank,
- transportation of wood for or/by forest industry company.

Tax deduction of tax paid to subcontractors

Building contractors may now deduct from the tax payable on their turnover, the tax invoiced to them by their subcontractors.

New rate

The general rate is increased to 9% (previously 8%).

The general rate (including additional council tax) is 9.90% on the taxable base including tax or 10.99% on the taxable base excluding tax. The other rates are unchanged.

4. REGISTRATION TAX

Contracts with state corporations

Registration tax on contracts signed with public bodies as state corporations is payable by the private contractor except when international organisations give or lend money in order to finance the contract. (Registration tax exempt must be written in the contract made with the international organisation.)

Mortgages

The 1984/85 Finance law modifies the rate of the registration tax payable on mortgages.

The rate is 1% on mortgages not exceeding 10,000,000 CFA francs and 0,5% on mortgages not exceeding 5,000,000 CFA francs.

Exemptions

Effective 1 July 1984, contracts relating to "social building credit" are exempt from registration tax.

MALAYSIA:

An Outline of the 1985 Budget Tax Proposals

By K.S. Jap

Mr. Jap is Principal Research Associate of the International Bureau of Fiscal Documentation, Amsterdam.

INTRODUCTION

On 19 October 1984, the Minister of Finance, the Honourable Encik Daim Zainddin, delivered his Federal Budget Speech to Parliament. He stressed that the Government must continue its policy of fiscal restraint in view of the problems faced by the Malaysian economy. The 1985 Budget strategy is aimed at:

(1) strengthening the balance of payments;
(2) strengthening the finance of the public sector, in an effort to sustain continuous economic growth and a stable financial position; and
(3) promoting private sector growth.

The measures to continue restraining public sector spending will reduce the Government's role in the economy. This will enable the private economy to play a more expansive and dynamic role in Malaysia's economic development. The new tax measures aim to provide incentives to every level of society to increase productivity and savings and to invest their savings. Given the Budget strategy and all the tax measures, expenditures and monetary policies, the Malaysian economy is anticipated to grow by 6.7% in 1985, compared to an estimated real growth rate of 6.9% in 1984 and 5.9% in 1983. The proposed tax measures for the federal financial year 1985, beginning 1 January 1985, were incorporated into the Finance Bill 1984 and the Share (Land Based Company) Transfer Tax Bill 1984.

The major tax changes and proposals announced by the Minister of Finance are outlined hereunder.

DIRECT TAXES

Tax changes to take effect as from 19 October 1984, i.e. Budget Day.

Imposition of tax on share transactions by land based companies

In order to cope with the avoidance of payment by land based companies of the 5% real property gains tax by selling company shares, a share transfer tax of 10% was introduced and levied on the disposal value of shares exceeding M$ 1 million by a company not listed on a Stock Exchange and having land as one of its assets.

With the introduction of the share transfer tax applicable to land based companies, there is a possibility that such a company holding assets for more than 6 years may take advantage of the tax system by disposing of the assets (instead of disposing of the shares) in order to avoid paying the 10% share transfer tax. Therefore, as from 19 October 1984, disposal of assets by companies in the 7th year and thereafter after the date of acquisition is subject to 5% real property gains tax. The tax on share transactions in land based companies will be implemented through a new law entitled Shares (Land Based Company) Transfer Tax Act 1984.

Revised tax treatment of exploration costs

At present exploration costs do not qualify for deduction until the project reaches production stage when a mining allowance is given. If the prospecting venture proves abortive the exploration cost is deductible from aggregate income in computing total income. With the aim of reducing the financial burden on the company during its exploration activities it is proposed as from 19 October 1984 that exploration costs be allowed as a deduction from the aggregate income as and when it is incurred.

The whole of the exploration expenditure will then be added back to the aggregate income when the prospecting is successful and a mining allowance will be allowed as a deduction from the mining income in accordance with the existing provisions.

Under the new proposal, a mining company will be given the option whether to select the new method of tax treatment of exploration costs or to remain under the existing provisions.

Estate duty changes

As a measure to further improve the administration of estate duty and to relieve the tax burden on beneficiaries when paying estate duty, as from 19 October 1984 the following changes are proposed:

(1) The exempt amount for estate duty be increased from M$ 600,000 to M$ 2 million for deceased persons domiciled in Malaysia and for non-domiciled persons from M$ 120,000 to M$ 400,000.

(2) The rates of estate duty to be changed as hereunder:

Rates of estate duty for deceased persons domiciled in Malaysia:

Principal value of the estate	*%*
First M$ 2,000,000	Nil
Next M$ 2,000,000	5
More than M$ 4,000,000	10

Rate of estate duty for deceased persons domiciled outside Malaysia:

Principal value of the estate	*%*
First M$ 400,000	Nil
Next M$ 400,000	5
More than M$ 800,000	10

(3) The statutory limit for transfer of property to be exended from 5 to 7 years.

(4) Only contributions to approved charitable organisations to be exempt from estate duty.

Restriction of exemption on employee's benefit of free passage from income tax

In the 1984 Budget, exemption of free passage from income tax was restricted to once a year and limited to an employee and the immediate members of his family.

It is now proposed, as from 19 October 1984, that employees should only be allowed to enjoy the tax exemption of free passage if:

(1) they travel by the national carrier of Malaysia or, should they travel on routes not served by the national carrier, the tickets must be issued by the Malaysian Airway System (M.A.S.);

(2) where the leave passage is taken by way of a group tour which includes destinations covered by the national carrier of Malaysia, the furthest destination along that route to and from Malaysian must be undertaken on a Malaysian national carrier, on tickets issued by such national carrier.

Other proposals which will take effect from assessment year *1984* are:

Tax incentive for the shipping industry

The shipping incentive introduced in the 1984 Budget has benefited both resident and non-resident operators of Malaysian registered ships. It is proposed, however, that the shipping incentive be confined only to residents operating Malaysian ships.

The definition of Malaysian ships will be spelt out in the Income Tax Act 1967, as amended.

Abolition of development tax and excess profit tax on income

Currently, payments made to non-residents in relation to technical services and rent from movable property as classified under Section A4 of the Income Tax Act 1967, as amended, are subject to withholding tax at 15% of the gross amount. Besides this, these payments are also subject to development tax and/or excess profit tax at 5% on net payments. It is proposed that both the development tax and the excess profit tax be abolished. This will be in line with the tax treatment of interest and royalty income which are subject to only the 15% withholding tax.

Other proposals which will take effect from assessment year *1985* are:

Revision of the individual income tax

Currently, the rate of the individual income tax varies from 6% to 50% for chargeable income not exceeding M$ 100,000. Chargeable income exceeding M$ 100,000 is subject to 55% tax. A rebate amounting to M$ 60 is given to all taxpayers and M$ 30 for wives. Besides this, the other taxes on individual income are a 5% excess profits tax and a 5% development tax. As a measure to increase incentives to produce more income, productivity, investment and individual savings it is proposed that the individual income tax structure be revised to reduce the income tax rates of the individual taxpayers (see Table I).

In addition, the exempt limit of the excess profit tax of 5% will be raised from M$ 100,000 to M$ 300,000 and the rebate of M$ 60 and M$ 30 for taxpayer and wife respectively be retained for chargeable income not exceeding M$ 10,000 but abolished for chargeable income exceeding M$ 10,000.

TABLE I

A comparison of individual income tax under the present structure and the proposed structure

Present structure		*Proposed stucture*	
Income brackets (M$)	*Rate %*	*Income brackets (M$)*	*Rate %*
1 - 2,500	6%	1 - 2,500	5%
2,501 - 5,000	9%	2,501 - 5,000	8%
5,001 - 7,500	12%		
7,501 - 10,000	15%	5,001 - 10,000	12%
10,001 - 15,000	20%		
15,001 - 20,000	25%	10,001 - 20,000	15%
20,001 - 25,000	30%		
25,001 - 35,000	35%	20,001 - 35,000	20%
35,001 - 50,000	40%	35,001 - 50,000	25%
50,001 - 75,000	45%	50,001 - 70,000	30%
75,001 - 100,000	50%	70,001 - 100,000	35%
> 100,000	55%	> 100,000	40%
> 100,000	+5%EPT*	> 300,000	+5%EPT

* EPT = Excess profit tax

From year of assessment 1985 onwards, tax rebate of $ 60 for taxpayer and $ 30 for wife will be confined to those having chargeable income not exceeding M$ 10,000.

Table II

Tax relief for children

	Present amount (M$)	*Proposed amount (M$)*
First child	800	650
Second child	700	750
Third child	600	800
Fourth child	500	800
Fifth child	400	800
Total relief	3000	3800

The tax deduction amounts for dependent children also will be increased (see Table II).

Restriction of income tax exemption to one pension only

Currently there are certain groups of people receiving more than one pension and all these pensions are exempt from income tax. In order to improve equity in the tax system, it is proposed that the tax exemption be limited to the highest pension received. Other pensions will be taxed.

Tax exemption on royalties from literary, artistic and translation works

In the 1978 Budget, royalties from literary and artistic works up to M$ 3,000 were exempted from income tax. As further encouragement for the production of literary and artistic works it is proposed that the tax exemption for royalties from literary and artistic works be increased from M$ 3,000 to M$ 6,000.

Further, in order to increase the production of textbooks for higher education and to overcome the shortage of Bahasa Malaysia textbooks, it is proposed that income up to M$ 3,000 received from the translation of books be exempted from income tax. This exemption is restricted to translation undertaken at the request of the Ministry of Education and the Attorney General's Office only.

Capital allowance for motor vehicles used for commercial purposes

The capital allowance for motor vehicles used for commercial purposes has not been revised since it was introduced in 1975. Therefore, it is proposed that the allowance be increased from M$ 15,000 to M$ 25,000.

Taxation principles with respect to leasing industry

Presently the Income Tax Act 1967, as amended, does not have any specific provisions relating to the taxation of the leasing industry. In view of this there are problems such as dinstinguishing a genuine lease from a hire purchase or extended payment arrangement and abuses relating to capital allowance claims. In order to streamline the tax administration in relation to the leasing industry it is proposed to amend the Income Tax Act 1967 as follows:

(1) Section 36 as amended to give power to the Director General of Inland Revenue to prescribe rules and regulations pertaining to the leasing industry, and
(2) Section 39 be amended whereby allowance expenditure in respect of rent paid for a hired motor vehicle be limited to M$ 25,000.

Tax deduction on expenditure for purposes of cleanliness and beautification

Under Section 44(6) of the Income Tax Act 1967, as amended, a tax deduction is allowed for cash donations to the Government, State Governments or institutions or organizations approved by the Director General of Inland Revenue. Under the present law, local Governments are not covered in the definition of either Government or State Government. To enable cash contributions made to a local Government, such as for purposes of cleanliness and beautification, to be exempted from tax, it is proposed that Section 44(6) of the Income Tax Act 1967 be further amended by inserting immediately after the words "State Government" the words "local authority".

INDIRECT TAXES

Stamp Ordinance

As a measure to further improve the administration of stamp duties and to standardize duty on instruments related to the operations of Bank Islam and other banks, it is proposed that amendments be made to the Stamp Ordinance.

(1) Stamp duty on primary security in the form of stock, share and fixed deposit receipts be amended from a fixed rate of M$ 3 to 0.5% ad valorem, so as to be in line with other primary securities.
(2) Stamp duty will be imposed on the original loan only and duty on other securities and instruments for the same loan will be subject to a rate not exceeding M$ 10.
(3) Stamp duty on "Letter of Hypothecation" (mortgage deed) be levied at a fixed rate of M$ 3.
(4) Life insurance policies not exceeding M$ 5,000 be exempt from stamp duty in order to encourage savings and insurance through the relief of stamp duty on the lower income group in acquiring such policies.

These proposals will be effective from 1 January 1985.

Import duty and excise duty

To give protection to the national car project which is expected to commence production in 1985, it is proposed that the import duty on completely knocked down (CKD) cars be increased from 30% to 40%. The import duty on completely built up (CBU) cars and the excise duty on locally assembled cars costing more than M$ 13,000 will also be increased depending on their value as a means of maintaining some measure of parity between imported and locally assembly cars.

In order to provide higher protection to the local tire industry it is proposed that the import duty on tires for motor cars, trucks, buses and bicycles be increased.

Furthermore, to assist restaurant businesses it is proposed to exempt from import duty between 25% and 50% of certain foodstuffs imported into the country directly from the country of origin through local ports. The foodstuffs affected include fishmaws, shark's fin, duck eggs, abalone (25% exemption from import duty rate) and oysters, prawns, shrimps, crabs and cuttlefish (50%).

At least 9 excise duty rates will be changed from specific to ad valorem levy aiming to make revenue from these sources more responsive to price changes. The items affected include spa waters and aerated waters, beer, stout, playing cards, matches etc.

Uniform customs clearance at all entry points introduced

To facilitate customs clearance of incoming passengers, it is proposed that a single rate of import duty of 50% be imposed on all non-commercial goods brought into the country by these passengers. This single rate of import duty will apply to all goods other than motor vehicles, liquor, cigarettes, goods which are duty-free and goods on which duty has been exempted if brought into the country by any person who has been away from Malaysia for 72 hours or more.

Registration fees for motor vehicles

It is proposed to increase the fees payable for registration of new motor cars and the road tax on motor cycles and hire and drive cars under the Road Traffic Ordinance 1958. Increases will also be made for various other fees such as the transfer of registration numbers, examination of motor vehicles, etc.

IFA news

In memoriam

Dr. A. Heining

Wir trauern um Rechtsanwalt Dr. Arnold Heining, der am 21. Dezember 1984 im 71. Lebensjahr verstorben ist. Dr. Heining war dem *Bulletin for international fiscal documentation* seit vielen Jahren als ständiger Korrespondent für die Bundesrepublik Deutschland verbunden.

Seit den 50er Jahren war Dr. Heining in der Bundesrepublik Deutschland einer der ersten, die sich über wiegend mit dem internationalen Steuerrecht befassten. In seiner Tätigkeit beim Bundesverband der Deutschen Industrie in Köln hat er die wesentlichen Stationen des Aufbaus des internationalen Steuerrechts der Bundesrepublik Deutschland mitgestaltet. Hierzu zählen insbesondere der Ausbau des inzwischen sehr engen Netzes an Doppelbesteuerungsabkommen der Bundesrepublik Deutschland, darunter insbesondere das Doppelbesteuerungsabkommen mit der Schweiz von 1971, weiterhin das Aussensteuergesetz und die unilateralen Regelungen zur Anrechnung ausländischer Steuern. Die Arbeiten des deutschen Gesetzgebers und der Finanzverwaltung hat er aus der Sicht der international tätigen deutschen Wirtschaft wesentlich beeinflusst. Seine Mitgliedschaften in den Steuerausschüssen von ICC and BIAC in Paris und von UNICE in Brüssel zeigen den weitgespannten Rahmen von Dr. Heinings Aktivitäten auf. Seine schriftstellerische Arbeit hat diese Tätigkeiten wesentlich ergänzt. Hier sind vor allem hervorzuheben seine Kommentierungen des Doppelbesteuerungsabkommen mit Frankreich und des §34c EStG.

Angesichts dieser Fachcompetenz war es beinahe zwangsläufig, dass Dr. Heining auch in der IFA aktiv wurde. Aus der Arbeit der deutschen Landesgruppe seit 1960 ist er nicht mehr fortzudenken. Er war über 14 Jahre Generalsekretär der deutschen Landesgruppe und hat während dieser Zeit vor allem die bilateralen Kontakte zu den benachbarten IFA-Gruppen gepflegt und in zahlreichen gemeinsamen Veranstaltungen ausgebaut. Herausragt auch die Organisation des IFA-Kongresses 1964 in Hamburg. Vorbereitung und Durchführung des IFA-Kongresses 1981 in Berlin hat er ebenfalls noch wesentlich mitgestaltet. Seine vielfältigen Erfahrungen hat Dr. Heining auch in die internationalen Gremien der IFA, nämlich als Mitglied zunächst des Wissenschaftlichen Komitees und später des Generalrates, eingebracht.

Die Kenntnisse und Erfahrungen von Dr. Heining, aus denen er uns oft in schwierigen Fragen beraten hat, werden wir sehr vermissen. Wir trauern auch um einen guten Freund.

Dr. Karl-Dieter Wingert

We mourn the death of Dr. Arnold Heining, Rechtsanwalt (Attorney at Law), in his 71st year on 21 December 1984. Dr. Heining had been connected with the *Bulletin for international fiscal documentation* for many years as the regular correspondent for the Federal Republic of Germany.

Having started in the 1950s, Dr. Heining was among the first to preoccupy himself mainly with international tax law. Working with the Bundesverband der deutschen Industrie (Confederation of German Industry) in Cologne, he played an important part in co-determining the lines along which the foundations were laid for the development of international tax law in the Federal Republic of Germany. Most important among these were the building up of a very closely woven net of German double taxation treaties, among which special mention should be made of the double taxation treaty with Switzerland of 1971, the "Foreign Tax Law" (Aussensteuergesetz) and the unilateral measures for obtaining a credit for foreign taxes. He exercised an essential influence on the work of the German legislature and the Ministry of Finance from the point of view of the international sector of the German economy. His membership of the tax branches of ICC and BIAC in Paris and the UNICE in Brussels show the broad reach of Dr. Heining's activities. His work as an author completed the full picture of these activities. Special attention must be drawn to his Comments on the Double Taxation Treaty with France and on Section 34c of the Income Tax Law.

Taking into account his expertise it could not but be that Dr. Heining would have become active in IFA. Without his contribution, the work of the German branch since 1960 would have been unthinkable. For more than 14 years he was the General Secretary of the German branch and during that time he maintained first and foremost the bilateral contacts with the neighbouring IFA branches and fostered these during numerous common activities. The organisation of the IFA Congress 1964 in Hamburg is also to his credit. He was also actively engaged in the preparation and organisation of the IFA Congress 1981 in Berlin. Dr. Heining made his broad experience available to the international instancies of IFA, first as a member of the Permanent Scientific Committee and later of the General Council.

We will very much miss Dr. Heining's knowledge and experience, with which he often served us in solving difficult problems. We mourn a good friend.

TAX FRAME FOR ACCELERATED INVESTMENT

Domestic and Foreign

Annual Tax Conference of the Federation of Indian Chambers of Commerce and Industry

Under this title, the Federation of Indian Chambers of Commerce and Industry (F.I.C.C.I.) gave its annual tax conference an international approach. The conference was held 23-25 January 1985 in New Delhi and was opened by India's new Minister of Finance, Mr. Vishwanath Pratap Singh. The conference, attended by some 300 persons from the business community, dealt, in five working sessions, with several aspects of taxation as related to investment.

The first session, chaired by Mr. Harbans Singh, Secretary to the Government of India, was devoted to the main conference theme. The speakers were Mr. N.K.P. Salva, M.P.; Mr. K.N. Modi, Chairman, Modi Enterprises; and Alun G. Davies, C.B.E., Trustee of the International Bureau of Fiscal Documentation and Governor of the Asian-Pacific Tax and Investment Research Centre.

Dr. Raja J. Chelliah, Member of the Planning Commission, chaired the second session on "Tax and Related Considerations for Foreign Investment". The key-note address was given by Mr. R.P. Owens, Director of Taxes, Rohm & Haas Co., Philadelphia, followed by observations of seven specialists from industry, judiciary and academic circles, and a presentation of Mr. O.P. Vaish, Advocate and, as Vice-Chairman of FICCI's Taxation and Company Law Sub-Committee, one of the initiators of this conference.

The Vice-President of FICCI, Mr. D.N. Patodia, chaired the third session on "Taxation Structure: Global Perspectives". The five speakers forming a panel were Prof. J. van Hoorn Jr., Chief Executive of the International Bureau of Fiscal Documentation and Chairman of the Board of Governors of the Asian-Pacific Tax and Investment Research Centre; Mr. R.S. Randleman, Director of International Taxes, S.C. Johnson & Son, Inc., Racine (Wis), U.S.A.; Mr. Maarten H. Freck, Loyens & Volkmaars, Singapore/Netherlands; Mr. Frank Sixt, Stikeman & Elliot, Hongkong/Canada; and Mr. Stanley I. Ross, Director of Finance (S.E. Asia), Du Pont, Inc., Wilmington (Del.) U.S.A.

During the fourth session, the discussion focussed on "Fiscal Problems relating to Joint Ventures, Technical Collaboration, Transfer of Technology, Technical Services, and Foreign Technical Personnel". It was chaired by Mr. N. Subramanian, Chairman, Central Board of Direct Taxes. Nine speakers from various sectors introduced the subjects.

The fifth and last session was devoted to the "Problem of Double Taxation and its Avoidance through Unilateral Provisions and Tax Treaties". It was chaired by Prof. J. van Hoorn Jr. Most of the speakers were top officials of the Indian Revenue specialized in international tax matters.

There were three luncheon speakers dealing with the economic situation of India. They were: Mr. N. Narasimham, former Governor of the Reserve Bank of India; Mr. P.K. Kaul, Finance Secretary to the Government of India; and Mr. A.K. Sen, Union Minister for Law and Justice.

The general conclusion that may be drawn from this conference is that it constituted a forum for free and frank (and often critical) exchanges of view with regard to the Indian tax system and its effect on investments and the transfer of technology. It became apparent that the new Government of India takes a more open view of the need for the country to create a favorable investment climate, both as regards inward and outward investment, and it is to be expected that India will step up its participation in international tax developments. At present, India has comprehensive tax treaties with ten European countries of which six are with EEC countries; four treaties with other countries in Asia with three pending; and five treaties with African and Middle East countries, with three pending. Some of the treaties are in the process of being revised. A treaty with the United States is under negotiation with the tax sparing clause being the major stumbling block.

Prior to the conference FICCI had organised a special meeting for a briefing on the Asian-Pacific Tax and Investment Research Centre, Singapore and its significance for India. Prof. van Hoorn, chairman, and Messrs. Davies and Vaish, governors, explained the Centre's objectives and answered questions from the – very interested – floor. At the opening session of the Conference, the Centre's chairman was given the opportunity to give a brief address of welcome on behalf of the Centre as its sponsor, the International Bureau of Fiscal Documentation. It is to be expected that the Centre will receive active support from the Government and the business and professional community of India, as well as from Indian universities.

U.S.–JAPAN INCOME TAX TREATY[1]

Rev. Ruling 85-7

Tax on income of foreign corporations connected with United States business

THE FACTS

Taxpayer, a foreign bank organised under the laws of Japan, has a United States branch which is a permanent establishment in the U.S. engaged in the banking business within the U.S. In March 1981, branch borrowed money within the U.S. for use in its banking operations. In September 1981, branch borrowed money in Japan for use in its banking operations.

THE ISSUE

Does Section 1.882-5 of the United States Income Tax Regulations apply to the determination of a foreign bank's world-wide interest expenses allowed as deductions under Art. 8(3) of the U.S.-Japan Income Tax Treaty for purposes of computing the U.S. taxable income of the bank's U.S. permanent establishment?

THE LAW

Internal Revenue Code and Regulations

The applicable sections of the Internal Revenue Code (IRC) of 1954 are Section 882(a) relating to the taxability of a foreign corporation engaging in trade or business in the U.S. and having income effectively connected with such trade or business in the U.S.; and Section 882(c) which allows deductions only if and to the extent that they are effectively connected with the conduct of a trade or business within the U.S.

The applicable sections of the IRC Regulations are Section 1.861-8(e)(2) which prescribes rules for the allocation and apportionment of interest in the computation of taxable income from sources within the U.S. and from other sources; and Section 1.882.5 which provides a 3-step process for determining the interest deduction allowed a foreign corporation under Section 882(c) of the Code.

The Treaty

Art. 8(1) provides for the taxation by the U.S. of the industrial and commercial profits of a resident of Japan that are attributable to a permanent establishment in the U.S.

Art. 8(2) provides that there shall be attributed to the permanent establishment the industrial and commercial profits attributable to the permanent establishment as if it were an independent entity dealing wholly independently with the Japanese resident of which it is a permanent establishment.

Art. 8(3) provides that in determining the industrial and commercial profits attributable to the permanent establishment, there shall be allowed as deductions expenses that are reasonably connected with such profits, whether incurred in the U.S. or elsewhere.

Art. 2(2) provides that any term used in the Treaty and not otherwise defined shall have the meaning which it has under the laws of the Contracting State relating to the taxes which are the subject of the Treaty.

THE RULING

A previous Revenue Ruling, 78-423[2], determined, under the same fact situation, that Arts. 8(1), 8(2) and 8(3) of the Treaty do not affect the allocation and apportionment of a foreign bank's interest expense under Section 1.861-8 of the Regulations. The Ruling states that the Treaty does not provide a specific rule for the allocation of expenses and, in the absence of such a rule, Art. 2(2) indicates that the general domestic law of the U.S. is to be applied to determine the profits "reasonably connected" with a U.S. permanent establishment. Therefore, Rev. Rul. 78-423 applied, as general domestic law, the general allocation rule found in Section 1.861-8 to such interest expenses.

However, subsequent to Rev. Rul. 78-423, regulations applicable to foreign corporations were issued under Section 882(c) of the Code. Therefore, according to the instant Ruling, Section 1.882-5[3] is the general domestic law to be applied in determining the interest expenses "reasonably connected" with the profits of a U.S. permanent establishment. Therefore, Section 1.882-5, rather than Section 1.861-8, of the U.S. Income Tax Regulations will apply to the determination of a foreign bank's world-wide interest expenses allowed as deductions under Art. 8(3) of the Treaty for purposes of computing the U.S. taxable income of the bank's U.S. permanent establishment.

COMMENT

As Section 1.882-5 of the Regulations, which provides a 3-step process for determining interest deductions allowed a foreign corporation, supersedes Section 1.861-8 and is the general domestic law to be applied after 6 February 1981, Rev. Rul. 78-423, which applied a general allocation rule, is now obsolete.

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[1] United States - Japan Income Tax Convention, TIAS 7365, 1973-1 C.B.630.

[2] Rev. Rul. 78-423, 1978-2 C.B. 194.

[3] Section 1.882-5 applies to periods after 6 February 1981 or, at the option of the taxpayer, to: (1) taxable years beginning after the last taxable year ending before 6 February 1981, or (2) all open taxable years beginning after 1976, or (3) all open taxable years. T.D. 7939, 1984-1 C.B. 171.

IRELAND:

Taxation Policy for 1985-86

Extracts from the Financial Statement of the Minister for Finance, Mr. A. Dukes, issued on 30 January 1985.

DIRECT TAXATION

Taxation policy

Tax reform

The National Plan "Building on Reality" provides that there will be no increase in the overall level of taxation over the period of the Plan. This is the starting point for taxation policy in the present Budget. Given the overall budgetary constraints, it will be necessary to offset the reductions which I propose by a widening of the tax base and by limited tax increases in other areas. The overall result will be a very substantial improvement in the distribution of the tax burden, a gain in simplicity and, above all, a positive stimulus to economic activity and employment. The changes which I propose today will also eliminate a number of anomalies and open the way for continuing improvements over the next few years.

Income tax

All taxpayers benefit

Government policy in relation to personal taxation is that, over the period of the Plan, bands and allowances will be adjusted each year so that the overall income tax burden on taxpayers will not increase. In order to give effect to this in the coming income tax year, changes are being made in the income tax bands, allowances and exemption limits. I am also taking this opportunity, to the extent that budget constraints allow, to reorganise the income tax structure in order to remove some of the more marked disincentive effects and complexities.

I am increasing the personal allowance from £3,600 to £3,800 for a married couple and from £1,800 to £1,900 for a single person. In addition, the widowed person's allowance and the one-parent family allowance will each be increased by £100.

Last year I abolished the 25% band and widened the 35% band. This was a first step towards simplifying the structure for income tax deductions. This year I am making major changes which will benefit all taxpayers. The 35% band will be widened by 12½% to £4,500 for single persons and £9,000 for married couples. The four bands at present above the standard rate – at 45%, 55%, 60% and 65% – will be replaced by two bands, one at 48% and the other at 60%. The 48% band will be £2,800 for single persons and £5,600 for married couples. The balance of income will be taxed at the new reduced top rate of 60%.

This reform will effect changes all through the system. All taxpayers will benefit from the increase in allowances and there will be benefits from the changes in rates and bands for taxpayers all the way up the income scale.

Some 65,000 taxpayers who are now paying tax at the 45% marginal rate will, as a result of these changes, see their marginal rate reduced to 35% thus cutting by one-sixth the number of people paying tax at the higher rates. A further 80,000 taxpayers, who at present are paying tax at a marginal rate of 55%, will now have a top marginal rate of 48%. As result of the abolition of the 65% rate, more than 60,000 taxpayers will benefit from a reduction of their marginal rate from 65% to 60%.

In all, 220,000 taxpayers will experience substantial reductions in their marginal rates or become free of income tax. Some 124,000 taxpayers will see their marginal rate move from 45% to 48%, but the marginal rate will, as a result of the changes in allowances and bands, apply to a smaller amount of income than heretofore, so that the net effect for these taxpayers will nevertheless be a reduction in tax liability. The same is true of the 25,000 taxpayers whose marginal rate will move from 55% to 60%. For almost 430,000 taxpayers, the marginal rate will remain unchanged at 35%, while, for some 55,000, the rate will remain at 60% but for both of these groups the increase in personal allowances will result in a reduction in tax liability.

In line with these changes to the rates, bands and allowances, I am also increasing the general exemption limits for those on low incomes. The limit for single and widowed persons will be increased from £2,500 to £2,650 and from £5,000 to £5,300 for married couples. In addition, the age exemption limits are being increased from £2,800 to £3,000 for persons aged 65 years or over and from £3,300 to £3,500 for persons aged 75 years or over. These limits will be doubled for married couples. Marginal relief will continue to apply to incomes which do not significantly exceed these limits. The changes to the exemption limits and the increases in personal allowances will remove about 15,500 taxpayers from liability.

The cost of these adjustments will be £58 million in 1985 and £97 million in a full year.

This reform in the income tax system will have four main benefits.

First, it will benefit every taxpayer. Secondly, it should ensure that, in respect of income arising in the 1985/86 income tax year, the overall income tax burden on taxpayers will not increase. Thirdly, it achieves a worthwhile simplification of the tax code. Taxpayer, employers and the revenue authorities will all welcome this. Fourthly, overall, the new structure will substantially improve the incentive to produce more and to earn more. I am confident that this will be recognised by the many people who say that their motivation to work has been diminished by high marginal tax rates, and that they will fell again that extra effort is worthwhile.

The special PRSI[1] tax allowance and the temporary levy of 1% on income are to be renewed for a further year.

Last year, I exempted persons earning less than £5,000 a year or less than £96 per week from the income levy. I am now raising this exemption limit to £5,300 per year, which is the equivalent of £102 per week for employees.

The estimated cost of renewing the PRSI tax allowance is £55 million in 1985, while the renewal of the temporary 1% levy with the increased exemption limit will yield £41.2 million this year.

There will be improvements in a number of secondary allowances.

The *incapacitated child allowance* will be increased from £500 to £600.

The *blind allowance* will be raised from £500 to £600 and where both spouses are blind, from £1,200 to £1,400.

Last year, I made a substantial increase in the *allowance available where a person is employed to take care of an incapacitated taxpayer or taxpayer's spouse* and this year I am proposing a further increase from £2,000 to £2,500.

I propose to increase the ceiling on *relief for rent paid by older persons* to £1,500 for married couples and £750 for single persons and to reduce the age limit for eligibility from 60 to 55 years.

The cost of these improvements in 1985 will be £300,000.

Farmer taxation

Arrangements for the introduction of the farm tax, announced in the National Plan, are in hand, and the necessary legislation will be published soon. Farmers will of course continue to be liable for income tax up to the end of the 1985/86 tax year. I propose to extend the existing stock relief arrangements for farmers for a further year at a cost in 1985 of £3 million.

Incentive for land leasing

In order to promote the long-term leasing out of land by persons who are unable to work it to its proper potential, it is proposed to exempt from income tax liability, from 1985/86 onwards, the first £2,000 of leasing income obtained each year by a lessor of agricultural land who is over 55 years of age or who is incapacitated. In order to qualify for this concession, the lease from which the income is derived must be for a period of not less than seven years. The cost of the concession is not expected to be significant in the short term.

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[1] Pay-related social insurance.

Confining stallion fees exemption to Ireland

There will be a provision in the Finance Bill to confine the tax exemption on stallion fees to income earned from stallions at stud in this country. This change will ensure that the relief benefits the domestic Irish bloodstock industry only, as was originally intended, and not bloodstock operations outside the country.

Taxation of financial institutions

The bank levy will apply again in 1985 at a level of £25 million. I am looking at the possibility of making some adjustments to the basis for calculating the levy to ensure that it is operated as equitably as possible.

A higher tax contribution will be required from the Building Societies on interest and dividends payable to their investors. The composite rate of tax is being increased from 75% to 85% of the standard rate, giving a new rate of 29.75% for 1985/86. This will give an extra tax yield of £4 million this year and £10 million in a full year. Should any Society feel that this increase is unwarranted, the Revenue Commissioners will undertake a survey of depositors with a view to determining what the composite rate for that Society should be. I propose to make permanent the payment date arrangements for Building Societies introduced in 1984. The combination of this change and the increase in the composite rate adds £32 million to the pre-Budget tax revenue estimate for 1985.

Savings relief for older people

I am introducing a change in the tax relief for certain deposit interest to encourage older citizens to put their savings in safekeeping. For taxpayers who qualify for the age allowance, that is, taxpayers over 55 years of age, the present ceilings for tax relief on deposit interest are being doubled. This new arrangement will apply in respect of interest otherwise assessable for 1985/86.

Company taxation

At present, all companies are due to pay a first instalment of corporation tax 6 months after the end of their accounting periods. The due date for payment of the second instalment varies as between companies from 1 day to almost 9 months after the due date for the first instalment. The lack of a uniform second payment date for all companies is an anomaly which is hard to defend nine years after the introduction of corporation tax.

I propose to advance the second payment date so that all corporation tax will be due for payment 6 months after the end of an accounting period. To lessen the impact of this change on those companies which will be most affected, I am advancing the second payment date in the first instance by only 3 months for accounting periods ending in the year beginning on 28 February 1985. In no case, however, will the new second payment date be earlier than 6 months after the end of an accounting period. This change will yield £10 million in 1985. A similar advancement of the second payment date by a further 3 months in each instance will apply for accounting periods ending in each of the following two years. This will mean a single due date for payment of corporation tax for all companies by 1987 at the latest.

Continuation of partial relief from Advance Corporation Tax

The transitional arrangements under which Advance Corporation Tax is payable at 50% of the full rate will be extended to distributions made up to 31 December 1985. The cost of this extension of relief will be £2.5 million this year.

Incentives

Continuation of stock relief

The system of stock relief introduced in the 1984 Budget will be continued for a further year. This will cost £3 million in 1985.

Continuation of capital allowances

The 100% initial allowance for plant and machinery and the 50% initial and 4% annual allowances for industrial buildings, which were due to expire on 31 March, will be extended to 31 March 1983. There will be no cost in 1985.

Capital taxation relief for spouses

I propose to exempt from capital acquisitions tax inheritancers taken by one spouse from the other on or after today. It is estimated that this relief will cost about £0.5 million in 1985.

Stamp duty exemption for young trained farmers

The stamp duty exemption in respect of the transfer of land to young trained farmers, which is due to expire in July 1985, will be continued for a further year.

INDIRECT TAXATION

Value-added tax

In the course of my Budget Statement last year, I indicated that I would look at the possibility of a fundamental reorganisation of the VAT system. There is general dissatisfaction with the existing system and it is clear that we need a more rational arrangement which will give a better return in terms of efficiency and impact on the economy.

The present system gives rise to problems such as a high level of duty-free imports, both legal and illegal, substantial compliance costs for businesses, administrative costs for the revenue authorities and distortion of trading patterns. The main structural causes of these problems are the very high level of some VAT rates, particularly the 35% rate, the multiplicity of rates and the application of widely divergent VAT rates to related goods and services.

In considering the reorganisation of the VAT system, I had the benefit of the Commission on Taxation's Report on Indirect Taxation. The Commission recommended that the general objective should be to levy VAT at a single rate on as broad a base as possible. This would undoubtedly be the most efficient system, but the Goverment do not consider that a single rate is feasible at present, particularly because of the effect on food prices. They have, however, decided on a major rationalisation of VAT.

From 1 March 1985, the VAT system will comprise three rates, zero, 10% and 23%, rather than the present six.

Abolition of 35% rate

The 35% rate will be abolished: items now charged at 35% will instead be charged at 23%. This will reduce the tax on a wide range of household items, including for example radios, record players, tapes, soaps and detergents, toys, cutlery, pottery and glassware, bicycles and household durables, and on a wide range of industrial materials. This will minimise the incentive for consumers to purchase these items outside the State. It will also reduce costs for a wide range of businesses and services, including for example the cost of educational materials. It will ease the cash-flow burden of VAT for industry, both at point of import and for domestic transactions, since many inter-industry goods have been liable at the 35% rate. I expect this rate reduction to give a substantial stimulus to output and employment across a wide range of activity.

23% rate

The coverage of the 23% rate will remain unchanged, apart from two exceptions.

VAT on newspaper sales

The National Plan provided for a reduction in the VAT rate on newspaper sales from 23% to 18%. In line with the reorganisation now proposed, this rate will be reduced further to 10%. This will provide a substantial relief for Irish newspapers.

I will mention the second exception in a moment.

Reduction of 18% rate on tourism

The 18% VAT rate, which covers hotel accommodation and short-term car, caravan and boat hire, will be reduced to 10%. This will substantially improve the competitive position of registered businesses in these areas, with a consequent improvement in their capacity to attract new business and in their employment capacity.

These VAT reductions will allow price reductions of between 7% and 10½% for the items involved.

Exemption of theatres and live performances

I propose to exempt from VAT theatrical and other live performances which are at present at the 5% rate.

Increases

In order to complete this reorganisation of the system and at the same time provide part of the revenue required to finance the foregoing reductions, the following increases will apply:

- the 8% rate on adult clothing will be increased to 10%;
- the 5% rate will also be increased to 10%, involving mainly building, fuel other than electricity, certain agricultural contracting services, and car repairs;
- adult footwear, which is zero-rated at present, will be charged to VAT at 10%.

The flat-rate reimbursement of VAT to unregistered farmers will be increased to 2.2% in order to offset the effects of VAT increases on certain farm inputs.

Relief for building

In order to reduce the effect on the building industry of the increase in its rate of VAT, the Government will introduce a number of special measures.

Increased grant for first-time house-buyers

The level of grant for first-time owner-occupiers of new houses affected by the VAT increase is being increased by 75% from £1,000 to £1,750. An additional sum of £5 million is being added to the Public Capital Programme for this purpose.

Special new incentive for letting

A measure will be included in the Finance Bill to provide a tax incentive in respect of certain premises let for multiple residential occupation.

Concrete blocks

The second exemption which I propose in the coverage of the 23% rate is a reduction of the rate of VAT on concrete blocks from 23% to 10%. This will improve the competitive position of registered manufacturers and reduce the scope for evasion.

Fishery harbour development works

An additional sum of £0.5 million is being provided in the Public Capital Programme for fishery harbour development works.

A much greater proportion of public capital expenditure in 1985 than in recent years will benefit the building industry. The expansion in road construction, up 23% or £23 million on 1984, and educational building, up 17% or £14 million on 1984, will provide a boost to the industry. In addition, the building industry will benefit from the preservation of mortgage interest relief, the new £5,000 grant for local authority tenants and tenant purchasers who give up their houses and who acquire private houses, the increased rent relief for older people, the abolition of the 35% VAT rate, the income tax reform, and the general economic recovery which is being supported by this Budget.

Free fuel schemes

Free fuel schemes help to meet the heating needs of certain groups of people dependent on social welfare or health allowance payments. The present value of the weekly fuel voucher is £4 and the Government propose to increase it to £5 from October, the start of the next heating season. The cost of this concession, which will far more than offset the increase in VAT fuel, is £2.5 million this year and £5 million in a full year.

Motor vehicle parts: reduction in duty

Since the reduction in VAT on motor vehicle repairs and servicing in 1983 from 23% to 5% was offset by an increase in excise duty on cars, it is appropriate that today's increase in VAT to 10% should also be matched by a reduction in another tax. I consider, however, that it would be more appropriate to apply the reduction to motor vehicle parts rather than cars. This will reduce the tax differential between parts sold in the State and elsewhere. A reduction in the duty from 25% to 10% is proposed. This will be phased in over a short period, in consultation with the trade, in order to minimise the difficulties arising.

The overall effect of this reorganisation and simplification of VAT will be to facilitate economic and commercial activity, and it will be of considerable help in expanding employment. In addition, I expect a substantial and positive effect on the volume of both legal and illegal imports from Northern Ireland, to the benefit of manufacturers and traders here.

It is estimated that the net effect of these changes in VAT in 1985 will be a reduction in revenue of £9.2 million. This takes account of gains from reductions in evasion, improved efficiency in the system, revenue from purchases diverted back to domestic sources and a net once-off loss of revenue payable at the point of import.

Excise duties

Last October, following the announcement in the National Plan, a substantial reduction was made in the duty on spirits. This was designed to win back to domestic outlets the significant proportion of purchases of spirits which had been diverted outside the State and the expectation was that no loss of revenue would arise. It is too early to say whether this expectation will be realised. The indications so far are encouraging, though the initial disruption of the market arising from the reduction, as well as the fact that the full increase in demand will take time to emerge, resulted in the 1984 revenue receipts from spirits being less than they would otherwise have been.

Excise duties are an important source of revenue. Since most of them are specific rather than ad valorem duties, increases are needed each year even to maintain the real level of the duties. In order to meet budget targets, increases in some duties are necessary on this occasion.

Alcoholic beverages

No increase in duty on beer, wine or spirits
Because of the significant Exchequer cost which would be involved, I am not in a position to reduce the duty on beer or wine, as was done with spirits. There will not, however, be any increase in the duty on these products.

Cider and perry
There has been a very rapid growth in consumption of cider in recent years. The duty on cider and perry is very low compared with that on other alcoholic beverages and I consider that the gap should be narrowed. I am therefore proposing an increase, with effect from midnight tonight, of 20p per gallon in the duty, including VAT, on the ordinary-strength cider and perry, with a relatively smaller increase for middle-strength cider and perry.

Hydrocarbons

I propose an increase of 10p per gallon in the duty, including VAT, on petrol and auto-diesel, with effect from midnight tonight. Existing rebates on petrol to handicapped drivers will be increased to match the duty increase. The auto-diesel increase will not apply to scheduled road passenger services. The tax on auto-LPG will be increased by a roughly similar amount through the increase in the 5% VAT rate, so no excise duty increase is proposed.

Cigarettes and tobacco

I propose a tax increase of 10p on the packet of 20 cigarettes, with pro rata increases for cigars and other tobacco products. This will have effect from midnight tonight.

"Cigarette" lighters

The duty on "cigarette" lighters will be increased by 10p, or 13½p including VAT at 35%, with effect from midnight tonight. From 1 March 1985, when the VAT rate will be reduced from 35% to 23%, a further 10p excise increase will be imposed, which will broadly offset the reduction in VAT. These changes are designed to bring the tax on lighters more into line with that on matches.

The total yield from these increases is estimated at £44.6 million in 1985.

In the case of petrol and auto-diesel, increases in retail prices must await new maximum price orders to be made by the Minister for Industry, Trade, Commerce and Tourism, who will determine the appropriate implementation date. Today's duty increase is being applied against the background of falling pump prices in recent months, so that the net impact on the motorist over the period from November to February will be relatively small. In the case of other tax increases which apply from midnight tonight, 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 after tonight.

I propose also to make some concessions in the excise area.

Televisions: halving of excise duty

The excise duty on televisions, combined with the 23% rate of VAT, results in a big tax differential on these items between the State and Northern Ireland. While televisions cannot legally be imported duty-free by travellers, since they would generally exceed the £55 single item limit, it is clear that large numbers are imported illegally. The trade have been seeking a 50% reduction in the excise duty, in order to reduce these illegal importations. While I do not accept that this reduction would be self-financing, I feel that the level of illegal imports has grown to such proportions that a reduction is needed and I propose that a 50% excise duty reduction be granted from an early date. The timing of the reduction will be decided following discussions with the trade.

Duty refund on oil used by sea-fishermen

Sea-fishermen already benefit from a refund of part of the excise duty on the oil which they use, paying only a net 5p per gallon rather than the normal 8p. I propose to relieve them fully of this excise charge from 1 February 1985 by increasing the refund to 8p per gallon.

The loss in Exchequer revenue from these reductions and from the reduction in duty on motor vehicle parts announced earlier is estimated at £3.7 million in 1985.

Reduction in betting duties

Betting is an area where the level of evasion is reported to be high and it can be very difficult to obtain adequate evidence to sustain court proceedings. The 20% duty on off-course betting represents an exceptionally high effective level of tax on betting, since it is applied to the amount staked, not just to the net amount "lost" by the punters to the bookmaker. It is very difficult to know what the effect of a substantial reduction in betting duties would be. However, I feel that there is a reasonable possibility that the cost of a significant reduction would be relatively small. I propose to make such a reduction as an experiment to test whether this is so. Accordingly, the excise duty on off-course betting will be reduced to 10% with effect from 4 February next. The 1½% stamp duty on on-course betting will be abolished from 1 April next at an estimated cost in 1985 of £600,000. The whole position will be reviewed before next year's Budget.

Road tax

Turning to road tax, I propose to increase the annual tax on private motor cars by 50p per horse-power for cars of eight horse-power or less, by £1 per horse-power for cars between nine and fifteen horse-power, and £2 per horse-power for all cars of sixteen horse-power and over. These changes are specifically designed to favour smaller, more economical cars. I am also proposing that the very low rate of road tax on agricultural tractors and excavators be increased from £15 to £30 a year. These changes will take effect from 1 March and will yield an additional £7.5 million in 1985.

Tax collection

Attention was drawn in the National Plan to the urgent necessity to make the tax collection apparatus more efficient. Substantial improvements have been made in recent years. In particular, wide-ranging changes were introduced in the 1983 Finance Act and these are now beginning to have an important effect. The tax clearance certificate scheme for public sector contracts, which was introduced last June, is proving very effective. Collection, however, is still far from being satisfactory.

One of the biggest problem areas in the tax collection process is enforcement, where there is a large accumulation of arrears. I am determined that this log-jam should be removed. I am, therefore, setting up a working group to make recommendations to Government for substantial improvements in the enforcement process.

Overview of tax changes

The changes which I have proposed in our income tax and VAT systems will unquestionably improve the climate for enterprise, effort and employment. Taken together with the tax concessions in other areas which I have announced today, they show clearly the Government's resolve to minimise distortions and disincentives in our system, within the constraints imposed on us by the need to continue with the necessary adjustments to the public finances.

POST-BUDGET CURRENT REVENUE

The net effect of the tax proposals which I have made will be to raise an additional £82 million this year. This includes £33 million from the continutation of temporary tax measures, £58 million by way of increased tax revenue buoyancy arising from the measures announced today and a net reduction of £9 million from the other tax changes made. The total tax revenue estimate, which comes to £5,704 million, shows an increase of 7½% on 1984 which is broadly in line with the projected increase in nominal GNP, fully meeting the Government's commitment not to increase the overall burden of taxation. There is rather more uncertainty than usual about the tax revenue forecast, particularly in view of the major structural changes in VAT announced today. I am nevertheless confident that, following the pattern of 1983 and 1984, tax revenue will again this year be quite close to target. Total current revenue is estimated at £6,400 million. The tax changes in today's Budget will raise the consumer price index by about one quarter of a percentage point.

Table explanatory of current Budget 1985

Revenue			*£ million*				*Expenditure*
1. Tax revenue			5,622.0	1. Debt service and other central fund charges			2,250.0
2. Non-tax revenue			696.0	2. Supply services (non-capital)			5,318.5
			6,318.0				7,568.5
3. Add temporary tax measures to be continued:				3. Add new expenditure:			
Income levy	41.2			Social welfare	55.0		
Bank levy	25.0			Public service pay	108.0		
Income tax - building societies	28.0	94.2		Grants to local authorities	9.5		
Less:				Other	1.3	174.3	
PRSI allowance	55.0						
Stock relief	6.0	61.0	33.2				
4. Add new tax increases:				4. Deduct:			
Excise duties				Expenditure savings			
– tobacco etc.	17.5			– pay	30.0		
– hydrocarbons	27.1			– other	28.6		
– road tax	7.5			Estimated departmental balances	50.0	108.6	65.7
Income tax							
– building societies	4.0						
Corporation tax	10.0	66.1					
5. Deduct new tax reliefs:							
Excise duties	3.7						
VAT	9.2						
Income tax							
– rates and bands	58.0						
– other	0.8						
Corporation tax	2.5						
Stamp duties	0.6						
Capital taxes	0.5	75.3	-9.2				
6. Impact of Budget on tax revenue buoyancy			58.0				
7. Deficit			1,234.2				
			7,634.2				7,634.2

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In Memoriam

H.W.T. (Trevor) Pepper

It is with great sorrow that we announce the sudden death of Trevor Pepper, one of our oldest friends and for many years correspondent to the *Bulletin*.

Trevor Pepper joined the British Inland Revenue in 1931 and became an Inspector of Taxes in the late 1930s. During that time he was awarded a BSC degree from London University (Birckbeck College). In 1954 he was appointed Assistant Deputy Controller of Taxes in Malaya and was promoted to Controller before leaving for Malta on a United Nations mission. He received a Johan Manku Negara (equivalent to the British C.B.E.) for services rendered in Malaya and in 1964 in England an O.B.E.

After having completed his mission in Malta, Trevor Pepper had many further postings, both for the United Nations as well as for the British Government's Department of Overseas Development, as a Fiscal Adviser to a great number of foreign Governments, including those of Brazil, Guyana, British Virgin Islands, Seychelles, Solomon Islands, St. Kitts, The Falkland Islands and St. Vincent. All these countries greatly benefited from Trevor's vast experience in the tax field.

His last mission was to Jamaica upon the invitation of the Dutch Government where he was on a team of experts sent out to advise the Jamaican Government. He regularly sent articles about the tax system and problems in those countries for publication in the *Bulletin*.

A major contribution to the *Bulletin* was his *Tax Glossary* which explained a large number of tax terms. Because we had necessarily to publish the Tax Glossary in instalments, Trevor and the Bureau had just agreed upon bringing out an updated version in book form. It is very sad that we must continue without his valuable advice.

Trevor had many other talents as well. He wrote a number of plays which were produced and in Malaya he wrote an annual radio pantomime which was very successful. He was a very active member of the Rotary International – and where there was no Rotary branch – of the Lions Club and did a lot of work for charity in helping underprivileged groups.

We mourn a friend whom we admired for his knowledge and whom we loved as a person. May his soul rest in peace.

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SOMMAIRE

INHALTSVERZEICHNIS

FIRST ISSUE OF THE CIAT/IEF TAX ADMINISTRATION REVIEW

The agreement signed between the Inter-American Center of Tax Administrators (CIAT) and the Ministry of Economy and Finance of Spain provides for the publication of a tax administration review.

The *Tax Administration Review*, published jointly by CIAT and the Institute of Fiscal Studies of Spain, is to be widely diffused, in particular among the CIAT member countries, Spain and other European countries.

The first issue of the *Review*, dealing with "The Administration of Personal Income Tax", has now appeared. Articles are printed in the original language (Spanish, English, French or Portuguese). Future issues will include the organization of tax administration, VAT administration and the verification function.

Subscription cost is US$ 20.00 for 4 issues; free of charge to members of CIAT and the Ministry of Economy and Finance of Spain. Subscriptions should be made through check or money order in favor of CIAT, to the CIAT Executive Secretariat, P.O. Box 2129, Panama 9A, Republic of Panama.

The Financing Process in the Public Sector in Singapore

Tax and Non-tax Revenue

By Linda Low

Dr. Linda Low is Lecturer, Department of Economics and Statistics, National University of Singapore.

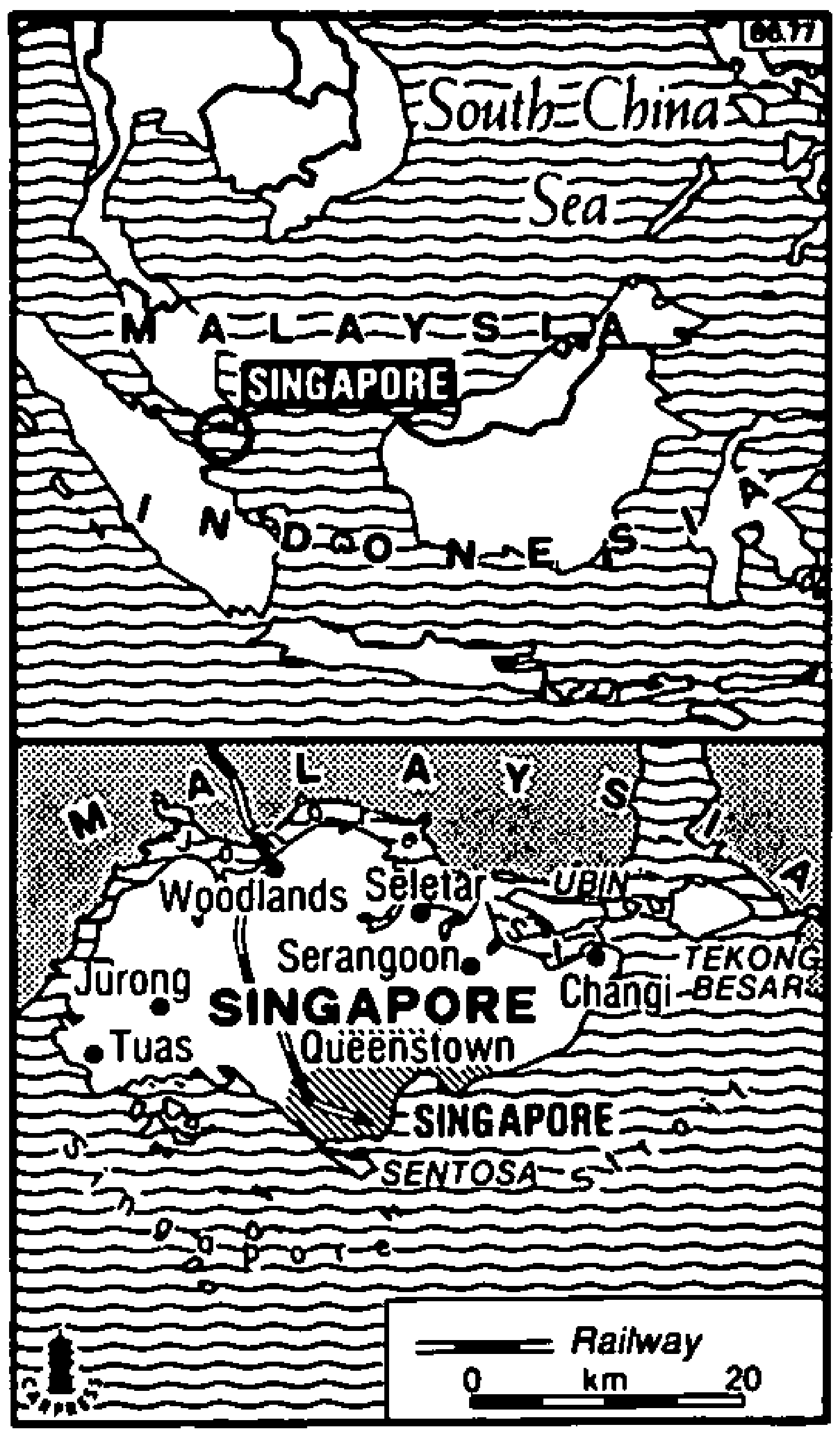
Contents

I. FINANCING IN A SMALL OPEN CITY STATE ECONOMY

This paper seeks to examine how the public sector has marshalled funds to finance capital formation and development in Singapore, whose development has been exemplary among developing countries.[1] The way the public sector has arranged its modes of financing affects the real sector of the economy, as well as mobilizes human activities to promote an environment conducive to development.

The problem of capital formation as it confronts public finance involves three areas of financing, which entails direct government financing as in social overhead, or intermediation as in intermediate investment, and in private investment. This overall responsibility of the public sector in appropriating resources to the private sector via fiscal policies, is one reason for the emphasis on public sector financing.

Another reason comes from the contention that the public sector constitutes the lead factor in the development process. Being a small open city state economy, Singapore's resource availability is constrained, and its options limited. With its peculiarities of size, lack of natural resources, and reliance on trade and commerce, the public sector has assumed the charting of the economic course, but still professes a "laissez-faire" disposition. The migrant, urbanized and denser population also needs to be galvanized to commit themselves. For their efforts, their rewards of economic and social well-being impinge upon the social provisions of education, health and housing facilities.[2] The sources of public sector financing examined comprise tax revenue, non-tax revenue and public sector borrowings. A bird's eye view of the public sector financial system is given in Figure 1.[3] Apart from the Consolidated Fund, the Development Fund and the Sinking Fund which form the financial budget of the government, other accounts include the Advance Accounts, the Contingencies Fund, the Deposit Accounts and the Skills Development Fund.



The statutory boards have their separate budgets which come under Par-

Abbreviations

AMCO =	Asset Management Committee
BCCS =	Board of Commissioners of Currency of Singapore
CAAS =	Civil Aviation Authority of Singapore
CPF =	Central Provident Fund (social security)
EDB =	Economic Development Board
GSIC =	Government of Singapore Investment Corporation
GSP =	Generalised Systems of Preferences
HDB =	Housing and Development Board
HUDC =	Housing Urban Development Corporation
JTC =	Jurong Town Corporation
MAS =	Monetary Authority of Singapore (central bank)
PAP =	People's Action Party (in power)
POSB =	Post Office Savings Bank
PSA =	Port of Singapore Authority
PUB =	Public Utilities Board
SDC =	Sentosa Development Corporation
SDF =	Skills Development Fund (training people)
STB =	Singapore Telephone Board
STPB =	Singapore Tourist Promotion Board
TAS =	Telecoms
URA =	Urban Redevelopment Authority

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1. The public sector here is defined to comprise the general government sector and major statutory boards as per listed in Table 10.
2. Ursula K. Hicks in "The Finance of the City State", *Malayan Economic Review,* Vol. V, No. 2, October 1960, p. 6, notes that the diverse and large immigrant population calls for very special efforts to build up a strong national and civic consciousness. Healthy and contented citizens are not only ends in themselves, but are also the foundations of a reliable labour supply for indigenous and foreign entrepreneurs.
3. A summary of government accounting poli-

liament's purview via their respective ministries' votes. While statutory boards are not the innovations of the People's Action Party (PAP) which has been in continuous power since 1959, its modus operandi has been to legislate statutory boards to undertake infrastructural development.[4] For other government-owned companies, though they are set up with state funds, they are not answerable to Parliament, except for the civil servant directors who act as checks and balances. With the passing of the Statutory Bodies and Government Companies (Protection of Secrecy) Act on 20 January 1984, as the Official Secrets Act does not cover these bodies, eir accounts are further secluded.

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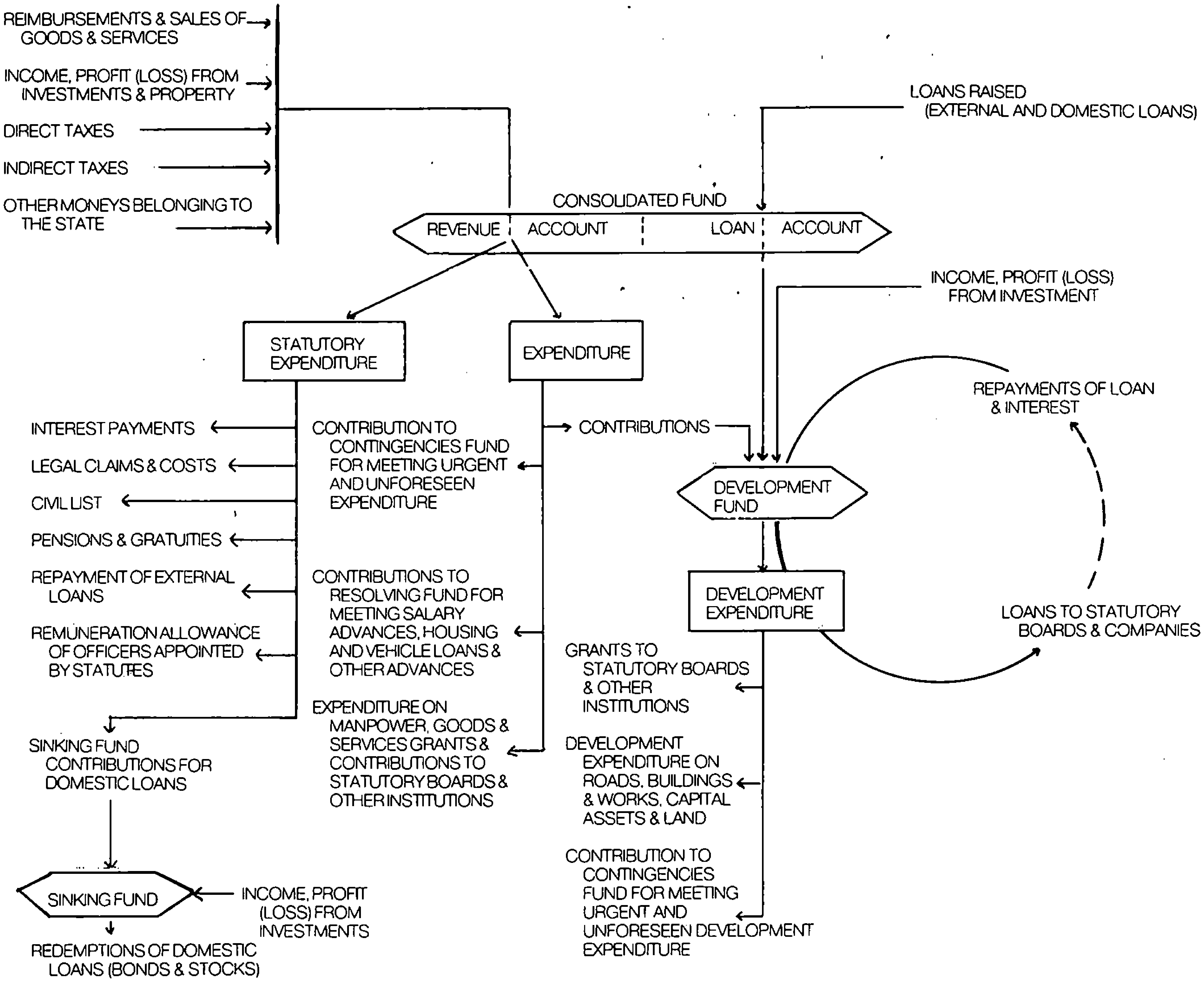
cies and traditions can be found in Singapore, *Report of the Auditor-General, 1980/81*, Appendix I, pp. 36-39. See also Mukul G. Asher, "The Fiscal System of Singapore", in You Poh Seng and Lim Chong Yah, eds., *Singapore: Twenty-five Years of Development*, Singapore: Nan Xing Zhou Lianhe Zaobao, 1984, pp. 78-107.

[4] Ronald Ma and PCK Tan, "Public Sector Accounts of Singapore 1966", *Malayan Economic Review*, Vol. XV, No. 1, April 1970 and Linda Low "Public Enterprises in Singapore", in You and Lim, *ibid.*, pp. 253-287.

Figure 1
Government sector financial system



Source: Singapore, *Report of the Auditor-General 1980/81*, Appendix II, p. 40.

The public sector financial system is thus complicated with many accounts and transactions or transfers among the various funds. To arrive at the financial position of the general government sector alone, or the public sector as a whole, such inter-fund movements and what accounts to include or exclude, must be carefully considered. This is, in addition to the other difficulties, due to different accounting practices and the financial year basis.[5]

Table 1 gives the government sector financial position for the period 1965 to 1981/82 (the table on government finance published in the Department of Statistics, *Yearbook of Statistics,* has been inexplicably omitted since the 1982/83 edition). For the government current budget position, that is, current revenue and current expenditure (column 6), surpluses of revenue over expenditure have been the rule since 1966. When this concept of deficit is widened to cover development expenditure as well (column 7), the result is still for surpluses to be achieved, though the size of the surpluses was reduced. Note that the revenue (column 2) used to calculate the overall surplus/deficit (column 7) is also widened accordingly to include the Consolidated Account, the Development Fund and the Sinking Fund. The financing of the overall surplus/deficit is via borrowing and accumulation of cash balances and foreign assets (columns 8 and 9). Until the whole public sector is considered in Section VI, the government sector, at least, appears flushed with funds.

II. MEASURES OF REVENUE PRODUCTIVITY[6]

As tax revenue constitutes the main source of finance (74.4% of total revenue in 1965 and 70.9% in 1982/83; see also Table 2), knowledge of productivity of various taxes, coupled with the public sector's policies on expenditure, consumption and saving, may guide the government when making trade-offs among various sources of financing. Tax revenue productivity is clearly important from the financing point of view. However, it is widely accepted that taxation is not only a means of raising revenue, but also fulfils other fiscal goals of allocation, distribution, stabilization and growth. Revenue productivity must therefore be consistent with these

Table 1
Budget balance and financing
$ million

								Financing of overall surplus/deficit	
	Current revenue	Revenue[a]		Expenditure current[b]	Development[c]	Current surplus/ deficit	Overall surplus/ deficit	Borrowing/ redemption	Use/accumulation (–) of cash balances + foreign assets
	(1)	(2)	(3)=(4)+(5)	(4)	(5)	(6)=(1)–(4)	(7)=(2)–(3)	(8)	(9)
1965	419.5	582.2	618.5	439.5	179.5	–20.0	–80.0	67.3	13.0
1966	585.2	622.6	678.4	477.8	200.6	107.4	–55.8	117.1	–61.3
1967	663.0	710.2	730.3	553.8	176.5	109.2	–20.1	329.3	309.2
1968	803.0	857.0	787.6	585.2	202.4	217.8	69.4	564.9	–634.3
1969/70	1261.2	1364.4	1195.6	920.4	275.2	340.8	168.8	54.6	–223.4
1970/71	1266.5	1333.0	1254.1	935.4	318.7	331.1	78.9	429.8	–508.7
1971/72	1468.5	1680.6	1591.2	1079.5	439.7	389.0	161.4	695.0	–856.4
1972/73	1749.3	1877.6	1837.1	1257.4	579.7	491.9	40.5	416.5	–457.0
1973/74	2219.2	2426.6	2376.5	1417.7	958.8	801.5	50.1	532.6	–582.7
1974/75	2556.9	2802.6	2639.3	1734.1	905.2	822.8	163.3	909.7	–1073.0
1975/76	3092.2	3398.6	3256.7	1981.4	1275.3	1110.8	141.9	1027.3	–1169.2
1976/77	3156.2	3581.2	3391.7	2200.1	1191.6	956.1	189.5	1918.1	–2107.6
1977/78	3555.5	4083.5	3830.9	2582.8	1248.1	972.7	252.6	1673.1	–1926.3
1978/79	3738.8	4351.0	4159.3	2752.3	1407.0	986.5	191.7	1620.9	–1812.6
1979/80	4603.0	5232.5	4868.3	3182.7	1685.6	1420.3	364.2	1657.3	–2021.5
1980/81	5903.5	6788.9	6381.5	3742.3	2639.2	2161.2	407.4	2363.3	–2770.7
1981/82	7862.2	8493.8	7876.5	4467.0	3409.5	3395.2	617.3	2607.8	–3235.1

Notes: a) From Consolidated Account, Development Fund Account and Sinking Fund Account.
b) Payments from Consolidated Revenue Account, and Sinking Fund Account, on a net basis, that is less contributions to Development Fund, interdepartmental transactions and contributions to Sinking Fund.
c) Direct development expenditure + net lending to statutory boards and enterprises.

Source: Singapore, *Financial Statements* and *Yearbook of Statistics,* various years.

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[5] Prior to 1969, the financial year coincided with the calendar year; 1969/70 became a 15-month period due to the changeover. Of the major statutory boards, the PUB and PSA are still on a calendar year basis, the EDB and the STPB switched over to a financial year basis in 1969/70, the HDB in 1973/74 and the JTC in 1977/78. The TAS (Telecoms) and the SDC adopted a financial year basis right from the time they were formed in 1972/73 and the URA in 1974/75.

[6] The measures are based on data which cover the period 1965 to 1979 only.

Table 2
Actual yields from revenue sources, 1965-1979
$ million

Year	Income tax[a]	Excise & petroleum prods[b]	Import tobacco prods	Duties liquor prods	Payroll tax	Property tax	Stamp duties	Other import duties	Sub-total	Total tax revenue	Total revenue[c]	$\frac{\text{Sub-total}}{\text{Total revenue}}$	$\frac{\text{Tax revenue}}{\text{Total revenue}}$	$\frac{\text{Tax revenue}}{\text{GDP}}$	$\frac{\text{Total revenue}}{\text{GDP}}$
1965	100.2	53.2	34.0	37.6	7.3	55.4	6.3	17.1	311.1	377.7	507.6	61.3	74.4	12.8	17.1
1966	110.5	54.8	45.3	40.5	9.6	73.1	6.4	31.0	371.2	437.9	585.2	63.4	74.8	13.1	17.6
1967	122.9	53.0	47.1	43.5	10.1	78.6	8.4	29.8	293.7	470.6	663.0	59.4	71.0	12.6	17.7
1968	157.6	57.2	58.2	51.4	11.1	88.3	10.5	32.4	466.7	555.0	803.0	58.1	69.0	12.9	18.6
1969	197.5	64.1	62.4	50.1	13.4	103.7	17.4	47.5	556.1	676.0	1261.2	44.1	53.6	13.5	25.1
1970	251.5	74.1	69.7	60.0	16.9	109.0	22.8	62.1	666.1	857.1	1266.5	52.6	67.7	14.8	21.8
1971	317.9	82.3	67.9	65.5	21.8	138.4	29.2	69.0	792.0	979.1	1468.5	53.9	66.7	14.3	21.5
1972	402.7	92.4	74.2	70.6	27.1	155.6	40.8	77.4	940.6	1142.3	1749.3	53.8	65.3	14.0	21.4
1973	562.7	107.8	93.5	91.8	35.2	200.2	74.4	106.9	1272.5	1523.5	2219.2	57.3	68.7	14.9	21.7
1974	846.7	117.7	99.7	95.0	44.4	253.2	44.8	80.7	1582.2	1874.2	1556.9	61.9	73.3	14.9	20.4
1975	1123.7	121.3	108.3	103.0	51.2	281.4	46.9	69.1	1673.9	2164.7	3092.2	54.1	70.0	16.2	23.1
1976	1153.6	125.8	120.0	107.6	59.3	331.9	56.8	88.8	2042.9	2316.8	3156.2	64.7	73.4	15.9	21.7
1977	1281.5	133.9	123.7	114.0	65.8	349.7	60.5	124.1	2255.0	2597.8	3555.5	63.4	73.1	16.3	22.2
1978	1279.9	143.3	126.7	129.5	74.9	388.4	80.4	144.9	2364.2	2794.6	3738.8	63.2	74.7	15.8	21.2
1979	1389.7	154.3	125.9	139.8	89.5	491.4	106.0	165.9	2659.5	3160.8	4603.0	57.8	68.7	16.1	23.4

Notes: a) Refers to collected personal and company tax.
b) Excludes exemption given to the PUB and industries for import duties on petroleum products.
c) Revenues credited to Consolidated Account only.

Source: Singapore, *Yearbook of Statistics*, various years and *MAS Quarterly Bulletin*, Second Quarter 1980.

other objectives of tax policy, especially, equity, growth and neutrality.

One measure of revenue productivity is the *buoyancy of a tax*, defined as the ratio of the rate of growth of actual revenue to the rate of growth of national income, namely gross domestic product. Buoyancy thus measures changes in tax revenues that are due not only to changes in tax rates and/or base.

On the other hand, the other measure, the *elasticity of a tax* is a ratio of the rate of revenue growth that would have occurred, in the absence of discretionary changes, to the rate of growth of GDP. In other words, the elasticity of a tax measures the ratio of percentage change in adjusted tax revenue to the percentage change in GDP. The adjusted tax revenues are derived by eliminating from the historical tax series, the effects of all factors other than income. Thus, elasticity of a tax is only representative of its underlying structural elasticity, if there were no discretionary changes. Buoyancy does, however, give an estimate of the responsiveness of the tax system, *including* discretionary changes and it therefore provides a measure of total tax effort. Moreover, the difference between buoyancy and elasticity estimates will measure the effect of discretionary tax policy during the period. While expenditure, like taxes, can also vary automatically with changes in income, expenditure buoyancies and elasticities are assumed to be identical. These measures for taxes differ because of discretionary changes.

An income elasticity gap, defined as the difference between government expenditure elasticity and tax revenue elasticity, is also estimated.[7] A positive income elasticity gap implies that the built-in revenue productivity of a tax system is insufficient to match the growth of government expenditures. This will mean that additional finances will have to be raised by various means: via an increase in the rate and/or base of existing taxes; the introduction of new taxes; increasing non-tax revenues; borrowing more domestically and/or from abroad; other means of deficit financing; or a combination of all of the above. Tax revenue can only be said to be adequate when the income elasticity gap is negative, meaning that the built-in revenue productivity of the tax system is more than sufficient to match the growth of expenditures, reducing or eliminating the need to raise additional finances, given the same fiscal structure.

To estimate tax elasticity, some adjustment procedures to obtain a "cleaned" revenue yield series, that is a series from which effects of discretionary tax rate and/or base actions have been removed from the historical tax series, are necessary. If elasticity was estimated using historical tax series, the forecast would involve the assumption that all discretionary changes, defined as changes in the legal rates and bases, and a once-and-for-all change in the degree of administrative efficiency, which occurred during the period, would be replicated and would have the same effect over the period to be forecasted.[8]

There are three commonly used approaches for adjusting the historical tax series: (i) the constant rate struc-

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[7] For the period 1966 to 1974 see Mukul G. Asher, "Singapore Fiscal System: Is There an Income Elasticity Gap?" *Malayan Economic Review*, Vol. XXII, No. 1, April 1978, pp. 14-36.

[8] Approaches to estimate elasticity without using a "cleaned" tax series are discussed in Roy W. Bahl, "Alternative Methods for Tax Revenue Forecasting in Developing Countries: A Conceptual Analysis", Unpublished IMF Working Paper, October 1972.

ture method, (ii) the proportional adjustment method and (iii) the dummy variable method.[9] Of the three methods, the constant rate structure method is the most demanding in terms of data requirements; requiring fairly disaggregated data on the base and the effective rates. The next most demanding is the proportional adjustment method which requires an estimate of the amount of revenue gain or loss resulting from the discretionary change in the year of change. The method needing the least data requirements is the dummy variable method, where only knowledge of the significant changes and the dates of change need be noted. This method can be used whenever the constant rate structure method cannot be applied due to data limitations, or when neither the constant rate structure method or the proportional adjustment method is suitable if rate changes have significantly affected the bases. It fails for too short a time series or for too frequent discretionary changes.

In summary, the constant rate structure method, suitably adjusted, was applied to the personal and company income taxes, import and excise duties for petroleum, tobacco and liquor products, and CPF (social security) contributions, which, being mandatory, affect household behaviour like taxes. For property tax and stamp duties, the dummy variable method is used.

To estimate the buoyancy and elasticity values, a double logarithmic function of the following form is used for all taxes and expenditures, except where the dummy variable is applied:

$$\text{Log}\,X = a + b\,\text{Log}\,Y$$

where

X = unadjusted tax or adjusted tax or unadjusted expenditure variable

Y = GDP.

The results of the estimates of buoyancy and elasticity for 1965 to 1979 are presented in Table 3. For selected taxes, their income elasticities are further partitioned into tax-to-base and base-to-income elasticities.[10] The tax-to-base elasticity estimated using adjusted tax revenue, indicates the progressivity of the tax structure and/or a given state of administrative efficiency. On the other hand, the base-to-income elasticity estimates the responsiveness of the base to income. Thus, if income is a perfect proxy measure for the base and if the tax base is measured in terms of its definition in the base year, the partitioning approach should give the same result as the traditional income elasticity approach. Table 4 gives the details of the regression equations for the partitioning of income elasticities of selected taxes, while Table 5 gives the tax-to-base and base-to-income elasticities. In Table 5, it can be seen that only some of the results obtained by the partitioning approach are fairly close to those obtained by the traditional elasticity approach (columns 4 and 1 respectively). The reasons for the divergence are because: (i) the assumptions mentioned above may not be satisfied, (ii) the estimates have been obtained by using a regression approach.

In Table 3, the tax buoyancy estimates were all greater than unity except for excise and import duties on petroleum, liquor and tobacco products. The elasticity values were also greater than unity except for excise and import duties on petroleum, tobacco and liquor products, and other import duties. Table 3 also shows the contributions of discretionary changes to revenue increase, estimated as the difference between 100% and the rate of elasticity to buoyancy. Discretionary changes of excise and import duties on tobacco and liquor products and CPF contributions have been most significant. Thus, despite the social objectives of using successive revisions in duties to discourage smoking and drinking, they have also been revenue productive.

The decomposition of the traditional elasticity into tax-to-base and base-to-income elasticities in Table 5 shows that for assessed personal income tax, its tax-to-base elasticity appeared to be mainly responsible for the high elasticity of this tax. In contrast, the base-to-income elasticity for assessed total income tax exceeded the tax-to-base elasticity. For import and excise duties on petroleum, liquor and tobacco products, base-to-income elasticities were smaller than tax-to-base elasticities.

The overall buoyancy, obtained by weighting the buoyancy of each category of tax by its relative share in total unadjusted revenue for the period, was found to be 1.27 if CPF contributions were excluded, and 1.49 if they were included as shown in Table 6. The same table shows that the overall income elasticity of all the taxes was 1.13 if CPF contributions were excluded, and 1.18 if included. The buoyancy gaps, on both net and gross bases, were negative, implying that the relative importance of the tax revenue sources in financing government expenditure have increased. For the income elasticity gap, the one on a net basis is more relevant as it is the expenditure of the government in the rest of the economy that needs to be financed. Its negative value implies that the built-in revenue productivity of the taxes in Table 2 was sufficient to match the growth of government expenditures. Hence, there is no need, for revenue purposes, to go further into measures, like increasing the rate and/or rate base of existing taxes, or borrowing more domestically or from abroad, or going into other forms of deficit financing.

In fact, reliance on some of these methods can be reduced if there is a need to meet other objectives of such sources of financing. For instance, the government could well afford reductions in tax rates of certain taxes if other objectives of that tax were more pressing. It need not worry about the resulting erosion in tax reve-

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[9] For an application see R.J. Chelliah and S.K. Chand, "A Note on Techniques of Adjusting Tax Revenue Series for Discretionary Changes", IMF, Unpublished Working Paper, August 1974.

[10] Symbolically the partitioning approach is as follows:

$$E_i = \frac{dT_{ij}}{dy_j} \cdot \frac{y_i}{T_{ij}} = \left[\frac{dT_{ij}}{dB_{ij}} \cdot \frac{B_{ij}}{T_{ij}}\right]\left[\frac{dB_{ij}}{dy_j} \cdot \frac{y_i}{B_{ij}}\right]$$

where

E_i = income elasticity for the jth year

T_{ij} =revenue from the ith tax in the jth year

y_j = income in the jth year

B_{ij} =base of the ith tax in the jth year.

Table 3
Estimates of buoyancy and elasticity of various taxes and expenditure, 1965-1979

	BUOYANCY					*ELASTICITY*					
	Regress-ed on	*Coeffi-cient of GDP*	*Constant term*	*R^2*	*Durbin-Watson statistic*	*Coeffi-cient of GDP*	*Constant term*	*Coeffi-cient of dummy variable*	*R^2*	*Durbin-Watson statistic*	*Contribu-tion of discre-tionary measures (%)*
Assessed personal income tax	GDP_{t-1}	1.29 (30.63)[a]	– 2.79 (–17.15)	0.986	1.086	1.37[c] (30.91)	– 3.17 (–18.55)	—	0.987	0.765	–6.2
Assessed company income tax	GDP_{t-1}	1.66 (53.34)	– 3.89 (–20.31)	0.988	1.147	1.64[c] (40.00)	– 3.83 (–24.28)	—	0.992	1.882	1.2
Total assessed income tax	GDP_{t-1}	1.53 (34.84)	– 3.32 (–19.04)	0.989	1.034	1.55[c] (41.43)	– 3.35 (–23.17)	—	0.992	1.688	–1.3
Total collected income tax	GDP_{t-1}	1.51 (41.74)	– 3.19 (–22.87)	0.993	0.508	1.56[d] (24.71)	– 3.38 (–13.91)	—	0.979	1.808	–3.3
Petroleum duties	GDP^c	0.67 (35.86)	– 0.57 (– 7.83)	0.990	0.867	0.57 (18.92)	– 0.13 (– 1.14)	—	0.965	0.593	14.9
Duties on tobacco products	GDP^c	0.64 (19.45)	– 0.60 (– 4.70)	0.967	1.258	0.13 (3.90)	1.55 (1.67)	—	0.539	1.038	79.7
Duties on liquor products	GDP^c	0.68 (41.19)	– 0.78 (–12.13)	0.992	2.887	0.41 (16.82)	0.38 (3.98)	—	0.956	1.221	39.7
Duties on petroleum, tobacco & liquor products	GDP^c	0.66 (47.20)	– 0.17 (– 3.08)	0.994	1.620	0.37 (15.94)	1.09 (12.00)	—	0.951	0.856	43.9
Other import duties	GDP, D	0.94 (9.83)	– 1.86 (– 4.98)	0.881	1.028	0.93 (9.48)	– 4.21 (– 4.77)	0.030 (–0.96)	0.896	0.894	1.1
Payroll tax	GDP	1.30 (59.01)	– 3.65 (–42.37)	0.996	1.245	1.30 (59.01)	– 3.65 (–42.37)	—	0.996	1.245	0
Property tax	GDP, D	1.07 (37.66)	– 1.93 (–17.48)	0.991	1.165	1.06 (35.82)	– 4.42 (–16.67)	0.004	0.991	1.289	0.9
Stamp duties	GDP, D	1.41 (12.92)	– 4.06 (– 9.48)	0.928	0.983	1.11[f] (6.92)	– 3.07 (–10.33)	0.030	0.948	1.665	21.3
CPF contributions	GDP	2.01 (49.00)	– 1.24 (–33.49)	0.990	0.963	1.29 (41.48)	– 2.31 (19.02)	—	0.956	1.602	65.0
Current expenditure (net)[g]	GDP	1.03 (44.51)	0.95 (–10.45)	0.993	1.243	1.03 (45.51)	– 0.95 (–10.45)	—	0.993	1.243	n.a.
Current expenditure (gross)[g]	GDP	1.13 (26.17)	– 1.29 (– 7.58)	0.981	1.156	1.13 (26.17)	– 1.29 (– 7.58)	—	0.981	1.156	n.a.
Development expenditure (net)	GDP	1.31 (20.00)	– 2.39 (– 9.31)	0.969	1.464	1.31 (20.00)	– 2.39 (– 9.31)	—	0.969	1.464	n.a.
Development expenditure (gross)	GDP	1.48 (27.30)	– 2.95 (–13.92)	0.983	1.268	1.48 (27.30)	– 2.95 (–13.92)	—	0.983	1.268	n.a.
Total expenditure (net)	GDP	1.12 (46.88)	– 1.12 (–12.00)	0.994	1.972	1.12 (46.88)	– 1.12 (–12.00)	—	0.994	1.972	n.a.
Total expenditure (gross)	GDP	1.24 (42.30)	– 1.55 (–13.43)	0.993	2.062	1.24 (42.30)	– 1.55 (–13.43)	—	0.993	2.062	n.a.

Notes:

a) Figures in brackets are t-values.

b) Estimated as the difference from 100% of the ratio of elasticity to buoyancy.

c) Based on adjusted tax revenue series using constant rate method.

d) Based on adjusted tax revenue series using proportional adjustment method and official estimates. If adjusted official estimates were used, the coefficient of GDP is 1.53 (48.46) and the constant term –3.25 (–26.76).

e) Using a lagged GDP, the following results were obtained:

	Regressed on	*Coefficient*	*Constant*	*Coefficient*	*Constant*
Petroleum duties		0.66 (22.82)	–0.49 (–4.33)	0.56 (14.58)	–0.06 (–0.39)
Duties on tobacco products		0.63 (17.19)	0.53 (–3.78)	0.13 (3.61)	1.59 (11.70)
Duties on liquor products	GDP_{t-1}	0.67 (32.08)	–0.71 (–8.85)	0.40 (13.48)	0.43 (3.79)
Duties on petroleum, tobacco & liquor products		0.65 (28.30)	–0.10 (–1.08)	0.36 (12.68)	1.14 (10.59)

f) Based on adjusted tax revenue series using official estimates and dummy variable method of adjustment. If dummy variable method were used with adjusted official estimates, the coefficient of GDP is 1.33 (14.16); the constant term 8.79 (–10.33) and the coefficient of dummy variable 0.021 (1.06).

g) All expenditures (current and development) exclude transfers to Development Fund to avoid double counting. Net expenditure excludes cost of inter-departmental transactions and contributions to Sinking Fund.

Table 4
Partitioning of income elasticities of selected taxes, details of regression equations, 1965-1979

Category	*Regressed on*	*Coefficient*	*Constant term*	R^2	*Durbin-Watson statistic*
Assessed personal income tax	Assessed personal income	1.27 (42.03)	– 4.54 (–20.18)	0.993	0.710
Assessed personal income	GDP_{t-1}	1.07 (28.03)	– 2.12 (– 6.24)	0.984	0.362
Assessed total income tax	Assessed total income	1.23 (39.64)	– 3.53 (–14.55)	0.992	1.289
Assessed total income	GDP_{t-1}	1.26 (40.83)	– 3.36 (–12.25)	0.992	0.518
Petroleum duties	Weighted petroleum quantity	1.05 (–11.68)	– 5.33 (22.23)	0.974	0.188
Weighted petroleum quantity	GDP	0.53 (15.48)	2.19 (15.89)	0.949	0.946
Duties on liquor products	Weighted liquor quantity	1.05 (6.77)	0.38 (0.62)	0.779	0.454
Weighted liquor quantity	GDP	0.29 (5.16)	0.60 (2.75)	0.672	0.716
Duties on tobacco products	Weighted tobacco quantity	0.39 (3.79)	2.42 (3.89)	0.525	1.398
Weighted tobacco quantity	GDP	0.31 (7.95)	1.45 (9.52)	0.829	1.089

Table 5
Partitioning of income elasticities of selected taxes, 1965-1979

	Income elasticity (1)	*Proxy base*	*Tax-to-base elasticity* (2)	*Base-to-income elasticity* (3)	*Income elasticity via partitioning* (4)= (2)x(3)
Assessed personal income tax	1.37	Assessed personal income	1.27	1.07	1.36
Assessed total income tax	1.55	Assessed total income	1.23	1.26	1.55
Petroleum duties	0.57	Weighted quantity*	1.05	0.53	0.56
Duties on tobacco products	0.13	Weighted quantity*	0.39	0.31	0.12
Duties on liquor products	0.41	Weighted quantity*	1.05	0.29	0.31

* See Table 4.
Source: As in Table 4.

Table 6
Buoyancy and income elasticity gaps, 1965-1979

	Without CPF	*With CPF*
Overall revenue buoyancy	1.27	1.49
Overall revenue elasticity	1.13	1.18
Expenditure elasticity (net)	1.12	1.12
Expenditure elasticity (gross)	1.24	1.24
Income elasticity gap (net)	–0.01	–0.06
Income elasticity gap (gross)	0.11	0.06
Buoyancy gap (net)	–0.15	–0.37
Buoyancy gap (gross)	–0.03	–0.25

nue, as overall revenue productivity would be sufficient to meet government expenditures. This implication is augmented by the negative buoyancy gap for the same period. As noted, such negative values mean the importance of revenue from the taxes studied has increased in financing expenditure. Consequently, if there is the need to stimulate the economy via less tax constraints, the policy can be supported, given the findings on buoyancy and income elasticity gaps.

The above findings are valid based on a number of qualifications. One is that the buoyancy and elasticity estimates have been made for the sub-group of taxes shown in Table 2. Other taxes like estate duty, other indirect taxes and the Skills Development Fund (SDF) levy, have been excluded. These taxes are likely to have elasticities lower than the average elasticity of the taxes included and, if brought in, could change the income elasticity gap. Furthermore, the expenditure policy of the government is another factor which can change the magnitude of the income elasticity gap. Specifically, the expenditure elasticity has been computed on the basis of expenditure policies of the 1965 to 1979 period. With the restructuring of the economy, new expenditure policies to cater to an older population, with higher per capita income, greater expectation of quality in the standard of living, more intensified manpower development and training and others, may result in higher government expenditure. Then, the income elasticity gap may be affected, and new options and sources of tax revenue may then become relevant.

III. TAX STRUCTURE AND POLICY

Thus far, Tables 1 and 6 reinforce each other in demonstrating revenue adequacy in the government sector. Singapore's tax effort ratio has also been found to be low, compared with other countries.[11] Its small tax base, especially for income tax, is at least, partially, until the 1980s, a result of the government's tax policy. Time and again, the philosophy of taxation has been reiterated as merely *"the stimulation of rapid economic growth to lay a wider tax base which would provide increased revenue sufficient to meet new requirements for Government expenditures".*[12] This policy has been rather successful, as tax increases were made only in 1968 in the face of recession and increased military ex-

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[11] See two studies in IMF Staff Papers, namely Raja Chelliah, Hessel J. Baas and Margaret R. Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-71", Vol. 22, No. 1, March 1975, pp. 187-205, and Roy W. Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analysis", *ibid.*, Vol. 18, No. 3, November 1971, pp. 570-608. There is, however, considerable criticism over the concept and data used in such international calculations of taxable capacity and tax effort. See J.F.J. Toye *ed.*, *Taxation and Economic Development*, London: Frank Cass & Co. Ltd., 1978, chapters by A.R. Prest, "The Taxable Capacity of a Country", pp. 13-32; R.M. Bird, "Assessing Tax Performance in Developing Countries: A Critical Review of the Literature", pp. 33-61 and Bruce R. Bolnick, "Tax Effort in Developing Countries: What Do Regression Measures Really Measure?" pp. 62-80.

[12] See *Hansard*, Annual Budget Statement 1973, Vol. 31, No. 9, Col. 534. The same reiteration is found in Annual Budget Statements 1971 and 1974, *ibid.*, Vol. 30, No. 9, 8 March 1971, Col. 591 and Vol. 33, No. 1, 4 March 1974, Cols 73-74 respectively.

penditure due to the British pull-out; and in the seventies, when social objectives and further recession necessitated greater revenue from higher taxes on non-essentials. Even in 1980, the government's guiding taxation principles include, one, *"the wider the tax base the lower the tax burden per capita"* and two, *"the need to spread income tax to cover as many individuals as possible;"* the widening of the tax base is *"to imprint in the minds of Singaporeans the importance of prudent fiscal and welfare policies since many will have a direct responsibility to pay taxes for Government social expenditures from their own incomes"*.[13]

However, such a passive taxation policy based mainly on the built-in aspects of taxes may be less satisfactory in the longer run when some discretionary changes and tax reforms may be necessary. These may be for equity and distribution needs, to promote growth, stabilization and productivity in the context of a restructured economy. It was in response to such fiscal objectives that reductions in the personal income tax rates were successively implemented as shown in Table 7. Of course, the shifting of emphasis to equity and incentives is possible also because there is ample revenue.

Taxation policy may also have been ad hoc rather than integrated partly because budgeting is strictly to meet expenditure for the next financial year with forecasted revenue for that year. This ad hoc revenue forecasting has been inherited from the line-item system of budgeting. With the Programme Budgeting System implemented since financial year 1978, more rigorous planning of revenue to meet a longer-term expenditure programme may be expected.

Another taxation policy which may be reviewed affecting both revenue and equity considerations is the practice of the government of giving tax incentives to promote worthwhile areas, namely, the finance and capital markets as well as the industrial sector. Whereas incentives for the latter are documented and provided for under the Economic Expansion Incentives (Relief from Income Tax) Act, fiscal incentives for the development of the financial centre have been given during annual budget statements. But a more serious criticism on such incentives is the neglect of such tax expenditures in budgetary and fiscal policies. Tax expenditures are revenue losses attributable to tax laws which allow a special exclusion, exemption or reduction from gross income, or which provide a special credit, a preferential rate of tax on deferral of tax liability, or any exemption or relief which has been introduced to ease the burden for a particular class of taxpayers, or to provide an incentive to promote certain activities which would otherwise not have been undertaken.[14] In spite of the conceptual and statistical difficulties of quantifying tax expen-

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[13] These remarks were made in the Annual Budget Statement 1980/81 in connection with the decision to lower personal income tax rates but not to increase tax relief for earned income. *Ibid.*, Vol. 39, No. 10, 5 March 1980, col. 631-632.

[14] Literature on tax expenditures include Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures*, Cambridge, Massachusetts: Harvard University Press, 1973; J.R.M. Willis and P.J.W. Hardwick, *Tax*

Table 7
Individual income tax reduction under revised rate schedules for various years of assessment

% unless otherwise stated

		Rates with effect from Y/A				*Average reduction in tax rate[a]*				*Effective tax at end points[c]*		
Chargeable income ($)	*Old rate*	*1978*	*1980*	*1982*	*1985*	*1978*	*1980*	*1982*	*1985[b]*	*1978*	*1980*	*1982*
0 – 2,500	6	5	4	4	4	18.8	19.9	nil	10.0	5.0	4.0	4.0
2,501 – 5,000	9	8	7	4	4	n.a.	16.8	18.5	10.0	6.5	5.5	4.0
5,001 – 7,500	12	10	9	7	7	n.a.	13.8	25.9	10.0	7.7	6.7	5.0
7,501 – 10,000	15	12	11	9	9	n.a.	12.0	23.6	11.9	8.8	7.8	6.0
10,001 – 15,000	20	15	14	12	10	n.a.	10.0	20.2		10.8	9.8	8.0
15,001 – 20,000	23	20	17	14	12	n.a.	10.4	18.4	13.5	13.1	11.6	9.5
20,001 – 25,000	25	25	21	17	15	n.a.	12.1	18.4	13.4	15.5	13.5	11.0
25,001 – 35,000	30	30	26	21	18	n.a.	13.0	18.6	13.2	19.6	17.1	13.9
35,001 – 50,000	40	35	32	25	22	n.a.	11.9	19.5	13.0	24.3	21.6	17.2
50,001 – 75,000	50	40	34	30	26	n.a.	12.1	17.8	12.4	29.5	25.7	21.5
75,001 – 100,000	50	40	36	32	29	n.a.	12.4	15.3	11.8	32.1	28.3	24.1
100,001 – 150,000	55	45	40	35	31	n.a.	12.0	14.0	10.3	38.6	34.1	29.6
150,001 – 200,000					34							
200,001 – 400,000	55	50	45	40	37	n.a.	11.0	12.8	8.5	44.3	39.6	34.8
400,001 – 600,000	55	55	50	43	39	7.8	10.3	12.5	8.4	47.9	43.0	37.5
600,001 – 750,000	55	55	55	45	40	n.a.	6.8	14.8		n.a.	45.4	38.6
Over 750,000	55	55	55	45	40	n.a.	n.a.	17.9	9.8	n.a.	n.a.	n.a.

Notes:
- a) The average tax cuts for all income brackets for 1978, 1980 and 1982 respectively are 14.6%, 16.1% and 13.0%.
- b) This is for average reduction in tax. From year of assessment 1985 onwards, a 10% rebate on tax payable of up to the first $10,000 of chargeable income will be given for each year of assessment.
- c) Not available for 1985.

Sources: Vol. 37, No. 7, 27 February 1978, Appendix I, cols. 425-426;
Vol. 39, No. 10, 5 March 1980, Appendix III, cols. 645-646.
Vol. 40, No. 6, 6 March 1981, Appendix II, cols. 377-378; and
Vol. 43, No. 5, 2 March 1984, Appendix I, cols. 426-459.

ditures, their presence and development ought to be noted in relation to government fiscal management and their effects on equity, efficiency and incentive.

IV. NON-TAX REVENUE GROWTH

On the whole, non-tax revenue comprising charge revenue (regulatory and non-regulatory charges and reimbursements for services) and capital revenue (rents, sales of land and income from property and financial claims) contributed between 26% to 29% to total revenue between 1965 and 1982/83. Right up to 1971/72, charge revenue exceeded capital revenue although the margin has progressively declined. From 1972/73 onwards, capital revenue took the lead. As shown in Table 8, revenue from interests and dividends and sales of land boosted their contributions to non-tax revenue especially in the 1970s. Such dominance by capital revenue over charge revenue is reflective of the value of urban real estate in a small city state. Moreover, the lack of an agricultural base or natural resources to produce a surplus for development, may have induced the government to make consumers pay economic rents for all goods and services provided, maintain certain profit levels and avoid public sector deficits.

Over the period, increases in fees have also contributed higher yields to non-tax revenue as the government passes higher production costs to the consumers. Typically, it is also the style of the leadership to use monetary deterrents to discourage certain undesirable social trends like higher parking fees, hospital and medical fees for the greater number of siblings born, and others. The government's policy of gradual removal of subsidies and social benefits is also discernible from its revision of hawker licence fees, school fees and medical fees. This reflects its rejection of state welfarism and underlines its economic rent-seeking tendencies. Its philosophy is to make almost every project pay its own way wherever possible, giving subsidies only as a means of redistribution. Such thinking and the resulting policies have generally been beneficial to economic growth, enhanced capital accumulation and the development of infrastructure, without the sacrifice of equity. Interestingly, as will be discussed in Section V, the top revenue earning departments have also been the ones which were converted into statutory boards, including the Departments of Telecommunications, Postal and Civil Aviation.

Since 1981/82, for capital revenue, the largest source came from land sales, comprising land sales and premium grants accrued since 1965 and sales from urban renewal sites since 1972/73, sanctioned by two pieces of legislation. There have been 11 land sales involving a total of 158.9 hectares so far. For land acquired for redevelopment in the rent controlled area, the Controlled Premises (Special Provisions) Act, applies. For other land not under rent control, the Land Acquisition Act prevails. This Act was passed in 1967 despite strong views presented to a select committee formed at the second reading of the bill by individuals and organisations which feared the government moving into private proprietary rights. An amendment of the Land Acquisition Act in 1973 fixed the market value of the acquired land as at 30 November 1973, or according to the market value as at the date of publication of the notification to acquire, whichever is the lower. The government has continued to peg compensation rates at 1973 prices so as to provide cheap public housing, since property prices were low in 1973, being the year of the oil crisis.[15] Furthermore, the government contends that higher property values are attributable to the efforts of the society and the government rather than the individual owners. On the other hand, when the government tenders off acquired land, the prices are higher than the compensation rates which are based on existing use because the potential use of the land for approved new developments is the yardstick. It is contended that such enhanced land values should go back to the government.

The financing of the Mass Rapid Transit System, projected to cost $5 billion at 1982 prices, is also to be from land sales. About 50% of the 255 hectares of reclaimed land at Marina South would be sold. But the timing would be crucial as the government could obviously stagger the sales to capture the best prices and at the same time stimulate the property market through such land sales.

Before capital revenue from land sales took the lead, that from interests and dividends dominated. All sources of funds created under the Minister for Finance come under the scrutiny and management of an Asset Management Committee (AMCO). This was formed in the late sixties, chaired by the Minister for Finance, and comprises the Permanent Secretaries for the Revenue Division and Development Division, the Accountant-General and the Managing Director of the Monetary Authority of Singapore.

In 1981, a new arrangement came about for the management of all assets and investments of Singapore. Under the AMCO's direction, the Monetary Agency of Singapore (MAS) and the Board of Commissioners of Currency (BCCS) which together perform the central bank's functions, including that of acting as the government's financial agent, were responsible for asset management. Both the MAS and the BCCS were faced with regular surpluses from the financial accounts of the public sector, coupled with regular overall balance of payments surpluses. Such surpluses were allowed to accumulate to amounts in excess of what was required to meet the legal obligations of the BCCS, or the reserves needed by the MAS to manage the floating parity of the Singapore dollar. It was felt that the two bodies had concentrated their investment strategies too much on the holding of a large portfolio of investments for the purpose of managing the float, to the neglect of man-

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Expenditures in the United Kingdom, London: Heinemann Educational Books 1978; and Mukul G. Asher, "Should Singapore Introduce a Tax Expenditure Budget?" *Singapore Management Review*, Vol. 5, No. 1, January 1983, pp. 71-76.

[15] *Straits Times*, 28 May 1984.

agement of assets held as long-term investment.[16] While the former stressed the holding of liquid assets of short-term maturities to enable the MAS to intervene and respond quickly in the market, the latter was more concentrated on capital appreciation in the long term.

With plans for a central bank scrapped in 1981 and the MAS and the BCCS restructured, the asset management function is now the responsibility of the Government of Singapore Investment Corporation (GSIC). This high-powered investment company manages and invests all surplus funds of the government and statutory boards. Its investment policies are not expected to necessarily follow orthodox central banking policies which tend to favour gold bullion and gold shares.

This new financial arrangement, headed by the Prime Minister, may also be seen as consolidating the management of public sector assets and foreign currency reserves into one body. Some of the directors of the GSIC are still involved either in the MAS or the BCCS. But the direction of power now appears to come directly from the top political leadership rather than from the Minister for Finance in his capacities as Chairman of both the MAS and the BCCS.

There are three stocks of capital funds which can be judiciously invested to generate more capital revenue, namely official reserves, balances of the Development Fund and investment and cash of the Sinking Fund, as shown in Table 9. A fourth stock is the SDF balance though it is smaller in comparison, being only $336.1 million as at 1982/83.

The robust state of official reserves in Singapore has been subjected to a number of views. One can start by contending that the massive build-up of funds by the CPF may have created a shortage of funds driving up interest rates which attracted capital inflow which in turn accounted for balance of payments surplus. However such capital inflow has been more long-term than short-term in nature, so it cannot be the interest differentials, but other corporate motives of foreign investors, which brought foreign investment in.

An alternative view would start with balance of payments surplus sourced mainly by capital inflows which may be induced partly by the government's efforts to correct the huge current account deficit, partly by the multinational firms' own corporate motives or a combination of these and other factors. Such inflow of foreign currencies leads to a corresponding increase in local currency supplied by the MAS, and after the exchange, the foreign capital goes to add on to official reserves. However, the increase in the money supply coupled with the money multiplier could lead to inflation if nothing is done. In Singapore, this inflationary tendency is aborted because of the CPF which acts as a captive market for the sterilization process. Apart from the CPF, domestic saving is also mobilized from the banking and private non-bank sectors as well as the public sector, as shown in Figure 2.

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[16] This dissatisfaction with the joint investment policies of the MAS and the BCCS is tied up with a report by the government's in-house Management Services Department about staffing, organization and administration. At around the same time the MAS was streamlined, the government also decisively abandoned the formation of a central bank.

Table 8

Sources of non-tax revenue of the Government sector, selected years

$ million

Economic classification	1965	1968	1971/ 1972	1974/ 1975	1979/ 1980	1982/ 1983
Charge revenue	92.0	165.3	297.7	301.7	449.5	842.7
Regulatory charges	17.9	41.1	84.2	120.1	237.3	553.3
Other sales & non-regulatory charges	34.6	99.2	160.2	125.3	197.8	254.3
Reimbursements for services	15.6	7.5	11.3	9.8	14.4	35.1
Other transfer receipts	23.9	17.4	42.0	46.5	*)	*)
Capital revenue	37.9	101.9	218.0	351.5	752.2	1816.3
Rents	9.4	12.2	27.2	42.8	50.3	97.4
Sales of land	3.0	9.3	50.0	141.6	285.7	1032.5
Interest & dividends	14.8	73.2	123.4	160.5	400.9	677.1
Financial claims	8.3	4.7	5.4	3.4	3.3	3.3
Overpayments & refunds	2.4	2.5	2.0	2.6	3.7	4.2
Others	—	—	—	0.6	8.3	1.8
Total non-tax revenue	129.9	267.2	515.7	653.2	1201.7	2659.0
Government non-tax revenue as % of government current revenue (reliance ratio)	25.6	31.0	35.1	24.9	26.2	29.1
Government non-tax revenue as % of GDP (effort ratio)	4.8	5.7	8.2	5.6	6.2	8.3

*) No longer applicable.

Source: Accountant-General, *Financial Statements*, various years.

Table 9

Total official reserves, balances of Development Fund and cash and investments of Sinking Fund

$ m unless otherwise stated

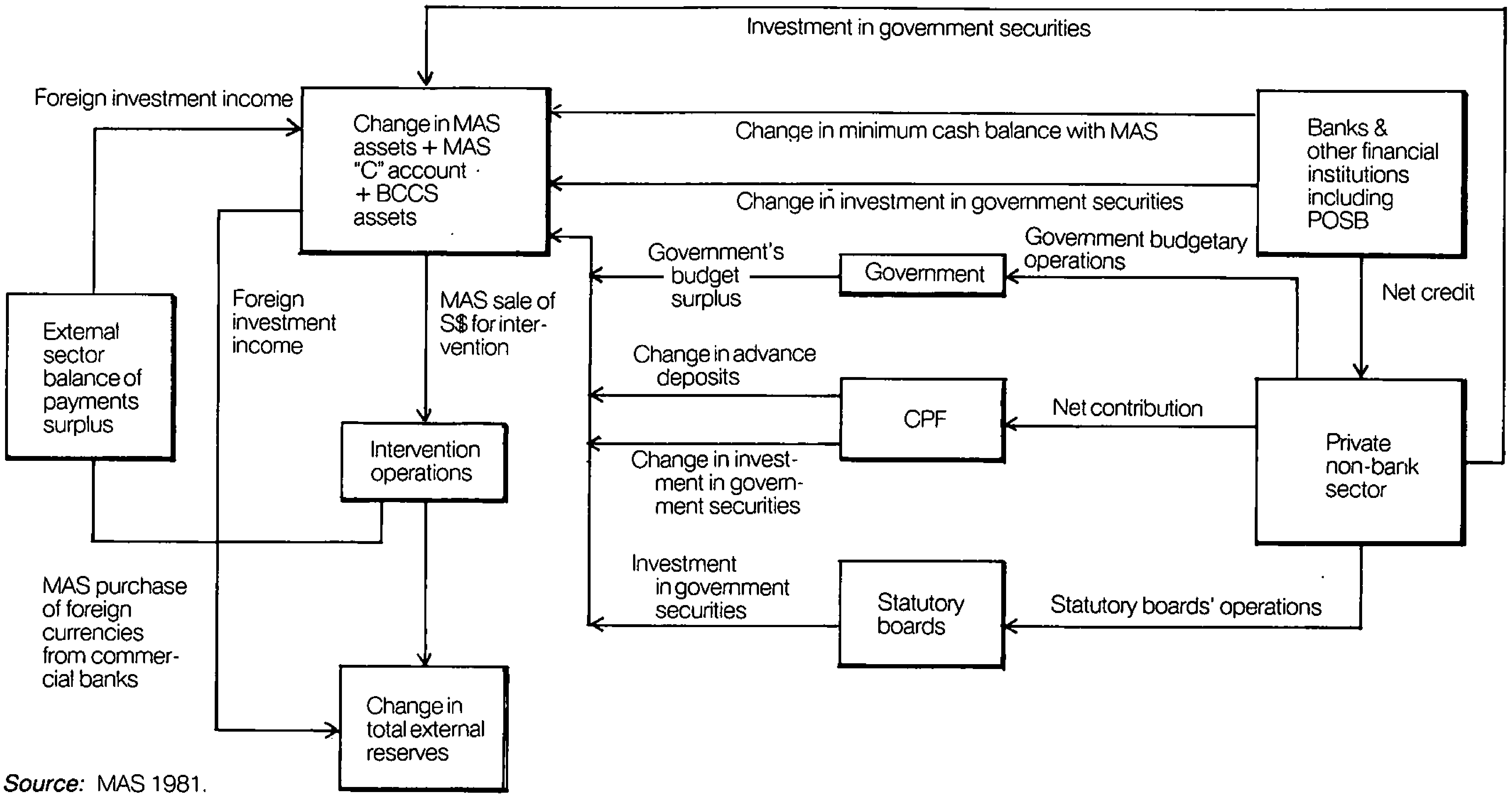
Year	Official reserves (1)	Development Fund: Balance each year: Beginning (2)	Development Fund: Balance each year: End (3)	Development Fund: (%) $(4)=\frac{(3)}{(2)}$
1965	1068.7	247.7	179.7	72.8
1969/70	3097.9	286.9	370.8	129.2
1974/75	7486.0	1295.6	1917.3	148.0
1979/80	15491.1	7669.9	8747.5	114.0
1982/83	19755.3	7321.3	7520.5	102.7

Year	Sinking Fund: Cash & investments (5)	Sinking Fund: Charge on account of public debt (6)	Sinking Fund: (%) $(7)=\frac{(6)}{(5)}$
1965	112.8	45.7	40.5
1969/70	366.6	255.2	69.6
1974/75	1680.8	552.5	32.9
1979/80	3628.1	1583.9	43.7
1982/83	8742.9	3079.0	35.2

Note: On calendar year basis; figures for 1982/83 refer to calendar year 1983. Singapore received its first allocation of Special Drawing Rights in January 1979.

Source: Singapore, Department of Statistics, *Yearbook of Statistics* and *Financial Statements*, various years.

Figure 2
Analysis of flow of funds to foreign reserves



Source: MAS 1981.

A slight variation of this view is that the build-up of funds at the MAS is quite, though not totally, independent of the external sector's contributions. The highly deflationary effect of budgetary operations of the government sector and statutory boards, including the CPF, has led to a tremendous mobilization of domestic saving. Coupled with the balance of payments surplus, much of which has accumulated since the 1960s, the sterilization of funds occurs. Such a sterilization of funds also attempts to attain three objectives simultaneously, namely, maintaining external equilibrium at a stable exchange rate, internal equilibrium, as well as high growth rates and employment, without inflation as will be elaborated in Section VI.

Concerning the balance of payments surplus position, it is prudent to note that a number of transactions not fully reflected in Singapore's balance of payments could constitute a statistical illusion. These include unrecorded trade with Indonesia, tourist expenditure on imports subsequently taken home by the tourists, and intra-company transactions by multinational firms. The very open nature of the economy plus complete abolition of foreign exchange controls since 1978 render balance of payments accounting arduous.

Combining both balance of payments surplus with the highly deflationary impact of the public sector the net effect is the accumulation of external reserves, which some observers believe are worth twice the official estimates, as items such as gold have been valued at prices at which they were bought. While the official reserves cannot be tapped, judicious management of the growing stock by the GSIC obviously has implications for financing since the profits of such investments go back to the Consolidated Fund.[17]

In the case of the Development Fund, the question asked would be why are there such large balances of funds at the beginning of each year? These balances are built up by the excess of sources (from Consolidated Revenue and Consolidated Loan Accounts and investment income) over the uses (government development expenditure and loans to statutory boards and enterprises). One reason could be the low levels of utilization of development expenditure. Such unutilised balances normally lapse and the voted estimates go back into the Development Fund. Actual expenditure as a proportion of authorised expenditure varied from 62.3% in 1965 to 77.6% in 1969/70, 72.5% in 1974/75, 90.0% in 1979/80 and 73.0% in 1982/83. The point is: there is no financial constraint to development projects and unutilised balances could be due to shortages of materials, manpower, execution time lag or even inadequate forecasting techniques. Poor fiscal marksmanship, in turn, may be deliberate to reflect the conservative fiscal management and to restrict demand for additional expenditures. Despite such healthy balances contributions from the Consolidated Revenue Account and borrowings from the Loan Account continue to be substantial; in 1982/83, these amounts were respectively 38.4% and 25.6% of total sources with other sources, mainly in-

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[17] The Prime Minister spoke of amending the Constitution to prevent future governments from spending foreign reserves without constitutional approval; see *Straits Times*, 16 April 1984.

vestment income, being the residual 36.0%. If funds are thus consciously being transferred by such deflationary budgetary operations; the accumulation of balances in the Development Fund is more deliberate than accidental; that is, they have not piled up merely due to shortages of resources to implement the projects.

The third stock of funds comprising the cash and investments of the Sinking Fund, set up specifically to ensure timely and orderly repayment of the domestic debt, again cannot be negated. However, expenditure on charges on account of the public debt has always been less than the cash and investments. It appears that the funds have grown so healthily partly because of returns from investments; and partly from the accelerated contributions since the eighties. The latter constitutes one way by which the government siphons surpluses from the Consolidated Revenue Account to be stashed away in the Sinking Fund. While reflecting an overly conservative practice, the resulting "deficits" in the government budget exonerate further borrowing and prudent policies.

V. REVENUE ADEQUACY OF STATUTORY BOARDS

Most statutory boards are self-financing with respect to their current budgets, exceptions being the Housing and Development Board (HDB), the Economic Development Board (EDB) since 1969, and the Sentosa Development Corporation (SDC). The others, namely the Public Utilities Board (PUB), the Telecoms (formerly the Singapore Telephone Board till 1973/74 and Telecommunication of Singapore till 1982), the Port of Authority of Singapore (PSA) and the Jurong Town Corporation (JTC), in that order, are the main revenue-generators, with the Urban Redevelopment Authority (URA) and the Singapore Tourist Promotion Board (STPB) being much smaller bodies. A point to note concerning the boards' incomes exceeding their expenditures is that they are exempt from income tax. For property tax, statutory boards pay a contribution in lieu of the tax. As for the PUB, it is further exempted from import duties on its petroleum imports. The loans for their capital expenditures are provided from the Development Fund and credit worthy statutory boards which borrow from external sources are also provided with guarantees by the government.

The implications for the financing process from the establishing of statutory boards to undertake the provision of some public goods and services can be summarised as follows. The fact that the statutory boards are generally self-financing within their respective budgets lessens the burden on the government budget. Indeed, statutory boards have made large contributions to overall public sector non-tax revenue. Current revenue of the above 10 statutory boards formed 65.3% of the public sector's total non-tax revenue in 1965, 65.9% in 1974/75 and 66.5% in 1979/80.

The size of their operating surplus is an indirect proof that they are not a burden, but, indeed, profitable assets (being wholly-owned enterprises) for the government. Individual boards, empowered by their respective legislations, can levy charges, generate other sources of income from their activities, borrow funds and form subsidiaries to diversify their activities and sources of income, among other functions, to enable them to remain self-financing. In certain cases like the HDB, subsidies from the government's budgets are required because of the social redistributive functions. In other words, being independent by status of their legislations, the flexibility and opportunities for statutory boards to levy charges and generate revenue on a more economic basis, exist. From time to time, they have revised their charges upwards to reflect rising fuel and manpower costs.

In contrast, government departments are restricted by the codes and rules of the civil service and are constrained by conformity to bureaucratic behaviour. This administrative disadvantage has been recognised by the government, as evidenced by the way and frequency with which it converts profitable and high-yielding government departments into autonomous boards; very obvious cases being the Telecommunications Department which merged with the STB to become the TAS in the first instance, and joined later by the Postal Department to become the Telecoms and the Department of Civil Aviation Authority of Singapore (CAAS).

Such conversions create a spatial distance between what a statutory board can economically charge and what a government department can charge for similar services. The former may be expected to operate on a more commercial and economic basis. While government departments levy charges mainly on a cost-centred basis, statutory boards can afford to be more profit-oriented since they are essentially public enterprises. There may also be fewer political problems when statutory boards pass on higher costs to consumers, and indeed, many even maintain healthy current account surpluses, as in the case of the PUB. The public is less likely to expect subsidization or welfare benefits from statutory boards, than they are from government departments. Finally, it must also be acknowledged that statutory boards have been so successful and have made large contributions to public sector non-tax revenue because the right environment has been provided by the government so that inefficiencies are minimised.

Nonetheless, the very success of the statutory boards and other government-owned public enterprises may be a source of contention. The major statutory boards like the Telecoms, the PSA, the JTC, the URA and even the HDB, are increasingly being run more on entrepreneurial and profit-maximisation principles, which, judged from one angle, is efficient. They may even be mindful that their boards do not become the least profitable in the public sector, but, rather, the most profitable. Civil servant directors in public enterprises may unconsciously run their government departments with the same zealous cost-efficient and profit-oriented motives. However, the fact that they are basically public enterprises with some privileges, like tax exemptions, power to levy charges and acquire land, among others, and had originally been established under more altruistic "raisons d'être" or functions, should not be side-stepped. As the anxious days of nation-building abate and development is more assured, competition in the economy becomes accentuated, especially in recession prone times. Most local firms are mindful of the presence of more resourceful multinational firms and public enterprises. At the extreme, a preemptive or crowding-out effect could affect indigenous entrepreneurship.

VI. PUBLIC SECTOR DEFICITS AND PUBLIC SECTOR BORROWING

Table 1 has shown that on an overall basis, that is including financing development expenditure, the government sector still enjoys surplus positions (column 7), such that borrowed funds, which exceeded these surpluses by many times, have led to accumulation of cash balances and foreign assets. From the previous section, the current account surpluses of the 10 statutory boards also appear healthy. Table 10 attempts to draw together the revenue and expenditure of the entire public sector. Referring to the bottom half of the table, on a current basis, both the government and the 7 statutory boards have robust surpluses for the period 1974 to 1983. On an overall basis, deficits showed except for 1979 and 1980 because of development expenditures of the statutory boards. But when government sector borrowing were brought in to finance the deficits, the borrowings more than covered the deficits and resulted in accumulation of cash and foreign assets. If foreign borrowings by the statutory boards were also included to finance public sector overall deficits, the accumulation would be larger.

Deficit financing, in the classical sense of borrowing to cover current account deficits, has thus been more apparent than real in Singapore since overborrowing has been accumulated in cash balances and foreign reserves. Apart from maintaining a conservative fiscal policy which is apparently perceived by the government as the "correct" policy, to invoke confidence and trust among investors, the creation of the public debt also needs to be rationalised from the perspectives of institutional requirements of the financial sector and the CPF, which must invest in government securities.

The public debt, covering domestic and external borrowings of the government, is dominated by the "funded debt" made up of long-term government securities which took up 62.5% of total debt in 1965,

Table 10
Public sector surpluses/deficits
$ million

Year	Government[a]		Statutory Boards[b]		Public sector		Financing of overall public sector surplus/deficit	
	Current[c]	Overall[d]	Current	Overall	Current	Overall	Govt Sector Borrowing	Use accum (–) of cash & foreign assets
	Surplus/Deficit		Surplus/Deficit		Surplus/Deficit			
	(1)	(2)	(3)	(4)	(5)=(1)+(3)	(6)=(2)+(4)	(7)	(8)=(6)+(7)
1965	– 20	– 80	25	– 125	5	–205	67	138
1966	107	– 56	39	– 127	146	–183	117	66
1967	109	– 20	54	– 220	163	–240	329	– 89
1968	218	69	78	– 291	296	–222	564	– 342
1969/70	341	169	74	– 104	415	65	55	– 120
1970/71	331	79	112	– 110	443	– 31	430	– 399
1971/72	389	161	140	– 207	529	– 46	695	– 649
1972/73	492	41	234	– 347	726	–306	417	– 111
1973/74	802	50	305	– 232	1075	–182	533	– 351
1974/75	823	163	296	– 777	1119	–614	910	– 296
1974	490	225	246	– 713	736	–488	910	– 422
1975	832	482	311	–1028	1143	–546	1027	– 481
1976	745	188	725	– 882	1470	–694	1918	–1224
1977	1186	478	835	– 903	2021	–425	1674	–1249
1978	1017	260	804	– 714	1821	–454	1621	–1167
1979	1525	629	1276	– 250	2801	379	1657	–2036
1980	1585	313	1822	– 277	3407	36	2363	–2395
1981	2059	306	2202	– 780	4261	–474	2608	–2134
1982	3373	1507	2651	–2060	6024	–553	n.a.	n.a.
1983p	4073	1999	3555	–2048	7628	– 49	n.a.	n.a.

Notes:
a) For government, revenue and expenditure cover those of the Consolidated Revenue, Development Fund and Sinking Fund Accounts, Current expenditure excludes transfer to Development Fund Account, but includes contributions to Sinking Fund Account.
b) For 1965-1974/75 (top half of table), these comprise 10 major statutory boards, namely HDB, JTC, PUB, PSA, TAS/Telecoms, URA, SDC, STPB, EDB and STB. For 1974-1983 (bottom half of table), only the first 7 boards are included.
c) Revenue less current expenditure.
d) Revenue less current and development expenditures.

Sources: For period 1965 to 1974/75: Table 1 and *Annual Reports* of various statutory boards, various years for period 1965-1974/75. For period 1974 to 1983: Table 1 and Singapore, *Annual Economic* Surveys, various years.

53.9% in 1970, 79.1% in 1980 and 73.7% in 1983. The external component was small, being 14.1% in 1965, 8.6% in 1970, 6.4% in 1980 and 2.7% in 1983. In the sixties, the U.K., especially, was the main source. Since Singapore launched its financial centre, borrowings in the capital loan market to establish Singapore's credit worthiness, beginning in 1972, have become the dominant external component.

In the domestic borrowing process, the chief instrument transferring financial resources from the private sector to the public sector is the CPF Board, as depicted in Figure 3. The CPF is consistently the largest holder of government registered stocks, with almost all of its funds, apart from a small proportion in advance deposits, fixed deposits and cash in hand, mandated for such holdings. Both rate increases in base changes, coupled with expanding money wages, work force and participation rates, have augmented the growth of CPF funds. Conventional wisdom has typified the CPF as a financing intermediary for the public housing programme in Singapore, helping to achieve a variation of "pension fund socialism" in Singapore.[18] Such an impression may have come about, both in respect of the CPF's large holdings of government securities which finance the HDB's building programme when the latter borrows from the Consolidated Loan Fund via the Development Fund as shown in Figure 2, as well as when the CPF allows its members to withdraw their CPF balance to buy their flats. The proportion of withdrawals under the Home Ownership Scheme has increased from one-fifth of all withdrawals in 1968 to over three-quarters in the 1980s.

Given the overall surplus position of the public sector and the phenomenon of overborrowing, the dubbing of the CPF as the financing agent for the HDB may be critically reviewed, especially in view of the government's warning that raising the CPF interest rate would mean higher cost of HDB flats.[19] Consider first the HDB's borrowings from the government, shown in Table 11. While the amounts outstanding have increased, the net loan, that is the amount disbursed less the amount repaid, or the change in amount outstanding, which reflects its current loan needs more accurately, was more modest. Moreover, the HDB's accelerated housing programme in the recession years, as in 1981, was as much due to the government's pump-priming activities as to satisfy the waiting list of applicants, both of which obviously affect its rate of borrowing.

Apart from the somewhat exaggerated demand of loan funds by the HDB, Table 12 also shows that though all receipts raised from loans, domestic and external, are transferred to the Development Fund from the Consolidated Loan Account, there are still surplus funds credited to the balance because of net receipts from Treasury Bills and advance deposits. The balance of the Consolidated Loan Fund (column 1) has thus been growing steadily. Furthermore, Table 12 shows that except for 1981/82, sources of funds for the Development Fund, of which loan funds from government registered stocks is only one source, have always exceeded the uses of funds. In 1972/73, for instance, receipts from government registered stocks formed 51.7% of total sources of the Development Fund and 85.1% of total uses. Up to 1977/78, such receipts constituted about one-quarter of total sources and between 10% to no more than 60% of total uses of the Development Fund. In 1978/79, the proportions were 33.3% and 61.1% respectively, dropping the 25.0% and 26.0% respectively for 1982/83. No such loans were raised in 1981/82 leading to a depletion of balances of the Development Fund. The point appears to be that even though the CPF is one of the largest lenders of funds to the government as it holds the lion's share of the funded debt, the CPF's role in financing the HDB is not quite that potent. Moreover as funds are fungible, it is even more difficult to tie the relationship down neatly and precisely.

Table 11
Statement of loans repayable to the Government by the HDB

$ million

	1 April to 31 March of FY		
FY	*Amt disbursed*	*Amt repaid*	*Amt outstanding on 31 March of FY*
1970/71	60.3	57.8	414.7
1971/72	104.3	3.9	515.1
1972/73	259.7	47.3	727.5
1973/74	373.8	10.9	1090.4
1974/75	456.8	111.5	1435.7
1975/76	584.0	148.2	1871.5
1976/77	655.1	294.4	2232.2
1977/78	717.9	441.6	2508.5
1978/79	662.0	481.3	2689.2
1979/80	834.5	472.4	3051.3
1980/81	1071.0	574.8	3547.5
1981/82	1464.0	612.0	4399.5
1982/83*	2253.0	575.0	6298.0

* Includes loans taken over from the HUDC and the JTC on 1 May 1982.
Source: As in Table 8.

If government borrowing, at least, its funded debt portion, is quite redundant for deficit financing, though in another, perhaps political sense, necessary to build up cash balances and official reserves, the growth of the public debt may be reasoned from the institutional demand of financial institutions. The growth of treasury bills has been in response to the development of existing financial institutions and new institutions like discount houses, offshore banks and finance companies. The increase in treasury bills reflects the liquidity portion of the money supply held by these financial institutions. Even the new issues of government registered stocks may have been prompted by the CPF's expanding funds due to base and rate increases, as it is mandated to invest only in government securities.

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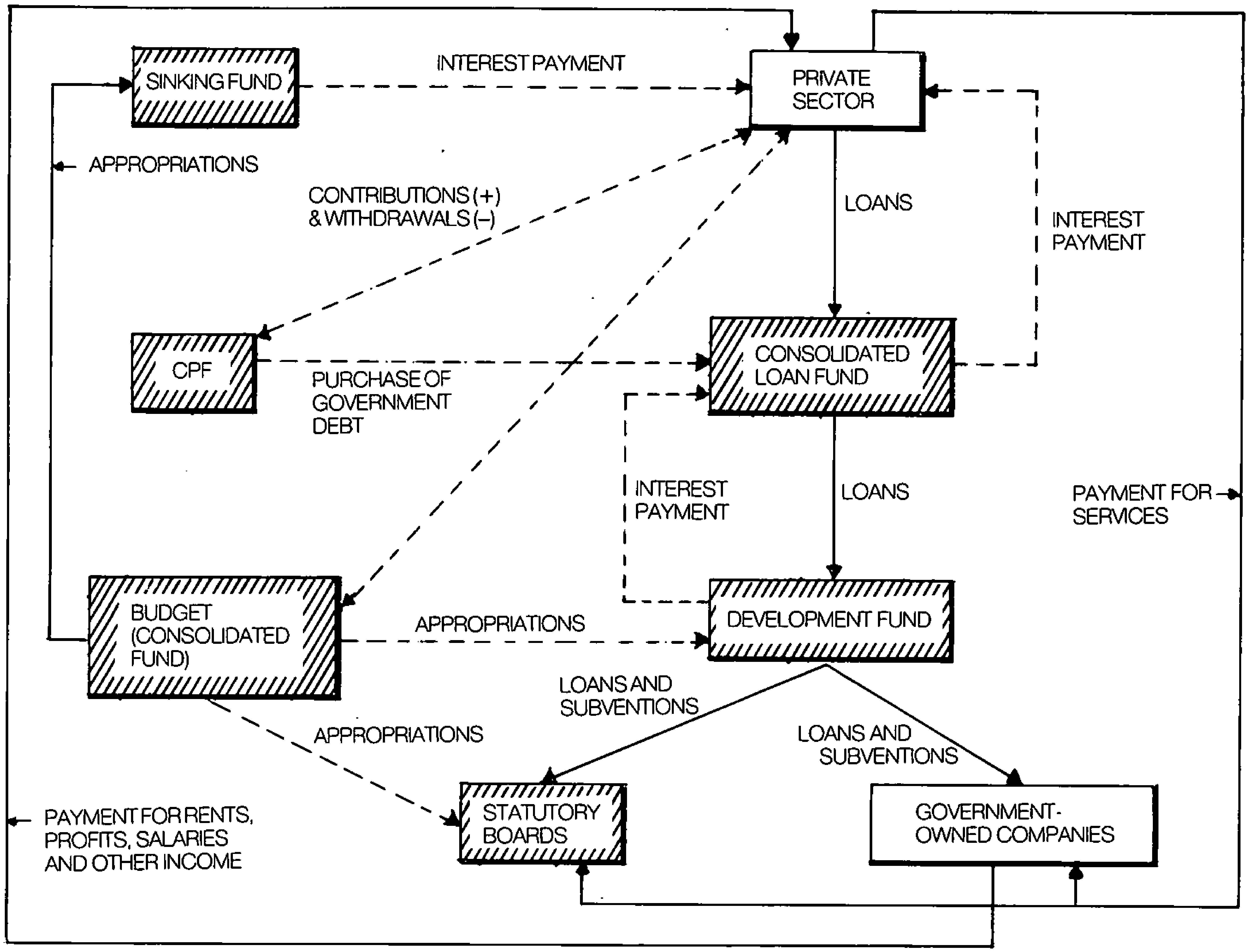
18. See Katrine A. Saito and Parthasarathi Shome, "Social Security Funds in Singapore and the Philippines: Ramifications of Investment Policies", ILO, *Labour and Society*, Vol. 5, No. 1, January 1980, pp. 19-30 and Chua Wee Meng and Ho Koon Ngiap, "Financing Public Housing", in Stephen H.K. Yeh, ed., *Public Housing in Singapore*, Singapore: Singapore University Press, 1975, pp. 58-80.

19. The then Minister for Communications and Labour, Mr. Ong Teng Cheong commented that higher CPF interest would have a boomerang effect on HDB costs; see *Straits Times*, 1 April 1983.

Figure 3
Flow of domestic funds between the private and public sectors



Legend: ▨ Public sector.

Given the deflationary impact of both the overborrowing via the CPF, as well as public sector surpluses on the current accounts, it is likely that a liquidity shortage is also created. This large drain of liquidity could well lead to capital inflow and foreign exchange intervention to restore domestic liquidity. Foreign exchange intervention is undertaken by the MAS in supplying Singapore dollars to buy up the foreign currencies brought in as capital inflow. Such an intervention has a triple effect of offsetting the public sector liquidity drain, increasing official reserves of foreign exchange (bought up when the MAS exchanges Singapore dollars for foreign capital flow) and retarding the appreciation of the exchange rate.[20]

The Deputy Prime Minister and Chairman of MAS, Dr. Goh Keng Swee, has further commented that the chronic surplus of funds in the public sector has absolved the MAS from having to worry about the various measures of money supply (M_1, M_2, or M_3, etc.), and the government, from bothering with the horrendous deficit in the balance of trade.[21] The funds sequestered into the CPF and government budget are recirculated to the banks when the MAS buys up foreign currencies which also serves the purpose of keeping the Singapore dollar from appreciating too much. The mechanism of sterilization of funds depicted in Figure 2 becomes operational and the MAS succeeds in keeping all the "balls in the air" with an "invisible hand". Singapore, by accumulating foreign reserves this way, is lending short (like holding foreign currencies) and by attracting foreign investments, is borrowing long. More important, foreign investment as a source of financing is desired for its dynamic accompaniments in the form of technology, skills, expertise marketing links and access to markets, more than the funds per se. While the appropriateness of the forms in which foreign investment has been invited in may be questioned, that Singapore needs the infusion is quite undeniable.

VII. EXTRAPOLATIONS FROM SINGAPORE'S FINANCING PROCESS

Tax revenue as a source of finance has been adequate, as indicated by the measures of revenue productivity and the continued prudence of government expenditure policies. Strong enforcement by the tax collecting departments would mean that the "natural" buoyancy

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[20] Colin Simkin, "Does Money Matter in Singapore?" Mimeo., Department of Economics and Statistics, National University of Singapore, Staff Seminar paper, August 1983.

[21] *Straits Times*, 25 August 1984.

and elasticity of the tax system with respect to GDP growth would suffice, without resort to "unnatural" means like tax rate changes or new taxes. Revenue considerations aside, other criteria of a good tax structure, like equity distribution, efficiency and stabilization, may be improved. Overall, the tax structure has still not been inimical to growth.

As for non-tax revenue sources, both charges and revenue from capital sources have been adequate. The business-like charging of public sector goods and services has been to inculcate thrift, avoid abuse in use, minimise deficit financing and maximise returns from available scarce resources. The self-financing operations of statutory boards also lessen the burden on general government budgetary financing together with other administrative advantages of their not being tied by bureaucratic rules and practices. Such a modus operandi has been greatly expedited by a dominant one-party system with overriding administrative and legislative leverage.

If the government relied only on tax and non-tax revenue to finance its current and development expenditures, deficit financing would be inevitable. But deficit financing in the case of Singapore appears more apparent than real. Borrowing, principally domestic borrowing via the CPF, has been in excess of public sector financing needs. The crux of the matter, whether there is overborrowing in the sense analysed above or not, depends essentially on how the growth in the public debt is viewed. If the debt was created largely because of institutional needs (by the CPF and the POSB and other financial institutions) for government securities, then there is no overborrowing as such. The debt grew as the financial sector grew. On the other hand, if the debt is viewed as a deficit financing mechanism, the loans raised have been more than sufficient to meet government development expenditure, and in fact have led to the accumulation of cash balances and foreign reserves (Table 12); overborrowing has occurred. While not denying that the public debt has to fulfil both needs, the characteristic prudence reflected in the ballooning CPF funds and accelerated contributions to the Sinking Fund, are indicative of some overborrowing.

The public sector has thus effected a strong intermediary financial role. This dominant influence of the public sector over the financial resources in the economic system is reflective of a small, open, city state which lacks an agricultural base to provide the surplus to finance economic growth. The public sector has taken upon itself to oversee the various sources, in order that financial resources may be maximised. The resulting financial procedures and system reflect the frugal and prudent policies of the leadership so much so that in terms of overall effects, fiscal policy with respect to the financing process has been deflationary on aggregate demand due to the government sector, although the effect due to the statutory boards has been more expansionary.

Unquestionably, the role of the fiscal authority over the various stages of development has definitely increased. Having been in continuous power since 1959, the PAP has become synonymous with the government, such that in reviewing the role of the fiscal authority, it is almost impossible to distinguish the two. It claims that its core functions and philosophy have not changed, and is consistently and firmly committed to free enterprise. However, because Singapore's survival options are small and limited, the leadership believes it also has to

Table 12

Statement of Consolidated Loan Account and Development Fund

$ million

	CONSOLIDATED LOAN ACCOUNT				*DEVELOPMENT FUND*			
FY	*Balance as at 1 Apr. of FY (1)*	*Receipts from govt registered stocks (2)*	*Other net receipts[a] (3)*	*Transfer to Development Fund (4)*	*Balance as at 1 Apr. of FY[b] (5)*	*Total sources[c] (6)*	*Total uses[d] (7)*	*Sources less uses (8)*
1970/71	525.9	78.1	485.3	372.2	370.8	543.6	380.5	163.1
1971/72	717.1	171.4	558.2	395.4	533.9	647.9	506.6	141.3
1972/73	1051.3	575.7	28.6	815.4	675.2	1113.5	676.5	437.0
1973/74	840.2	341.2	326.3	716.6	1112.2	1289.9	1106.5	183.4
1974/75	791.1	156.1	861.9	842.0	1295.6	1762.5	1140.8	621.7
1975/76	967.1	528.0	641.0	1303.3	1917.3	2292.0	1548.5	743.5
1976/77	832.8	949.5	1047.4	2043.2	2660.8	3456.0	1683.9	1772.1
1977/78	786.5	775.6	1110.2	1694.5	4432.9	3329.1	1890.0	1439.1
1978/79	977.8	1313.7	739.4	2022.5	5872.0	3946.8	2148.9	1797.5
1979/80	1008.4	1339.0	615.8	1698.5	7669.9	3380.8	2303.2	1077.6
1980/81	1264.7	1250.0	1634.1	2221.1	8747.5	4142.0	3654.5	487.5
1981/82	1927.7	—	3823.9	13.8	9235.0	3241.0	5154.7	−1913.7
1982/83	5738.0	1300.0	2521.2	1330.4	7321.3	5197.0	4997.8	199.2

Notes:
a) Comprise net receipts from Treasury bills, external loans and advance deposits.
b) Columns (1) + (2) + (3) – (4) would give the balance as at 31 March of the FY.
c) Comprise transfers from Consolidated Revenue Account, transfers from Consolidated Loan Account and others.
d) Comprise government development expenditure, loans to statutory boards and enterprises and others.

Source: As in Table 8.

be paternalistic and pragmatic. Hence it exerts itself judiciously especially where and when the private sector is lacking in direction and stimulus, practising a fundamentally eclectic economic approach to maximise economic prosperity under given constraints. Since the PAP government took office, right up to 1967, the fiscal role has been primarily long-range, optimising capital formation or emphasising more on allocation than distribution. It was only in the rapid growth stage, between 1968 to 1973, when the national cake was relatively larger, that distribution gained significance. With the recessions in 1974 and 1981, as the economy took the alternate beatings of world-wide inflation and recession, stabilization has become a greater preoccupation; not neglecting distribution as well.

Apart from this change in direction of fiscal policy, the financing process will operate under a different environment in the next decade. Firstly, the economy will be restructured as well as more open. A more open economy, may, on the one hand, mean more external sources of funds, or on the other, constrain policies to stabilize or insulate the economy from disruptive external influences. But being open is something Singapore will have to live with. Secondly, the expectation of fewer loan funds from international agencies in view of Singapore's development status needs to be reckoned with, even though such funds are not needed. Singapore convinced the IMF of its continued less developed status by showing indigeneous GNP out of total GNP has declined from 89.1% in 1968, to 81.7% in 1975, to 80.0% in 1983. While Singapore continues to get some assistance from GSP schemes, profits from sales of part of the IMF gold holdings and others, the graduation issue remains. Thirdly, the economy in the Eighties must contend with lower rates of economic growth in the face of international energy problems and other global problems related to recession, protectionism and debt. These issues will undoubtedly affect domestic revenue productivity as well as external sources of funds, namely private foreign investment.

In retrospect, while public investment in social and economic infrastructures and the financing of such capital formation were respectively high and difficult in the early stages of development, given a relatively smaller taxable capacity and low tax effort, these demands became less urgent after two decades of consolidation, by the Eighties. With the economy relatively more developed and private investment increasing, less of basic infrastructure and more of complementary public investment is required. There are also "fiscal dividends" to be reaped from the development of an income elastic tax structure as well as from the development of the financial and capital markets; more tax handles and other taxation expedients associated with rising rates of monetisation, literacy, compliance and administration. These plus factors for tax revenue productivity can be set against the above three more negative points.

Fiscal policy in Singapore on the whole can also be viewed as an adjunct to public sector investment policy because of the way it affects purchasing power and actual and potential consumption, as well as flow of investment. The tax structure and the policy of mandatory saving through the CPF amount to a form of check and regulation of private consumption. The loan of CPF funds to the public sector to finance what the latter considers as desirable channels of investment constitutes part and parcel of its overall investment strategy.

For the public sector, the financial system has brought about ample rather than deficient funds in spite of Singapore being a city state with resource handicaps. Other developing countries are normally more hard pressed for funds to finance the gargantuan tasks of nation-building and economic growth. In the Singapore case, a number of features which summarise the fiscal process may be offered to explain why it has a surfeit of funds.

First, with Singapore made pre-maturely independent by the split from Malaysia in 1965, the government was compelled to make sure that, financially at least, the country was strong. Financial strength and confidence reflected in the healthy balance of payments and official and monetary reserves have made possible the influx of foreign investments, technology, expertise and loans, making rapid economic transformation possible. Without the latter move to an industrial transportation services base, the traditional entrepôt trade would not have guaranteed the survival of the economy. An economic failure would then have been as good or as bad as a political failure. Thus, curiously enough, unlike other developing countries which are usually hard up for funds, Singapore's conservative financial attitude has more than sufficient resources.

Secondly, the wealth of funds has also been the result of the politicization of the fiscal process. The state of dominant one-partyism since 1959 makes the change or amendment of administrative rules and laws which affect the financial capability of the public sector relatively easy. While the state of legislative overkill may not have been reached yet, the set-up does help the government garner more financial resources. Examples of such legislative means include the CPF Act, the Local Government Integration Act, the Land Acquisition Act and so forth. Such legislation, enabling a wider command over financial resources, seems to have compensated for the difficulty of obtaining funds arising from the city state status and the lack of an agricultural base.

Thirdly, the desire to make whatever available scarce resources it has earn their economic worth, reflected in the government's entrepreneurial and capitalistic tendencies, has also caused, in part, the large contribution from non-tax revenue. Nothing is for free and even if certain goods and services are subsidised, the public sector uses the policy to remind the people against abuse, and that they should be obligated to fiscal providence.

The dominant one-party state, coupled with the entrepreneurial and capitalistic tendencies of the government, has resulted in the proliferation of statutory boards. From the financing angle, this administrative development has enabled the government to use the budget to finance development expenditures of the statutory boards. Hence the boards undertake public sector functions on a commercialised basis without overburdening the bureaucracy since, apart from subventions and loans from the Development Fund, they are essentially autonomous in their financial and operational affairs. This means of budgetary funds for quasi-bodies rather than dependending on relatively more inflexible government bodies, has perhaps expedited development projects greatly.

Fourthly, there is in Singapore a unique mechanism which supports the use of conservative fiscal policy to attract greater financial abundance. Through the increase in the rates of contribution of the CPF, which is also greatly aided by expansion in money wages and employment due to economic growth, the public sector has effectively borrowed domestic private sector saving for its public investment. Insofar as the public sector is merely spending what the private sector has saved, the process is non-inflationary. Whatever is not used for financing is effectively stashed away as foreign reserves. Such CPF funds plus other cost saving devices like cheap land through compulsory land acquisition, in financing public housing projects for the mass of the population, have perhaps helped to keep prices down, making Singapore generally competitive in terms of labour costs and cost-of-living. The avoidance of inflationary public sector financing, a feature usually experienced in other developing countries, is also due in part to the retention of the Currency Board System.

Finally, it may be noted that financially, economic development in other developing countries may mean the prior solution of deep-seated and complex political, social and economic problems, before resources are available or mobilised. Singapore, since 1965, has become relatively cohesive in all three aspects such that the government can go about garnering financial resources without much trouble. This is a very important prerequisite because if there were any political or social turmoil, investments would be scared off and domestic saving might even take flight. In turn, this cohesion is due to the astute leadership Singapore has enjoyed during this period. The leaders have generally seen to good housekeeping being practised and have ensured that the openness of the economy is developed to the people's advantage.

These five characteristics thus contribute to the uniqueness in Singapore's sources of funds, which may not have their parallels in other developing countries. The public sector even has a choice of sources of funds to use in pursuit of the multifaceted goals of fiscal policy.

On the other hand, a fiscal dilemma also emerges from the above. While surpluses from the Government's current account, stashed away as accumulation of cash balances and foreign reserves, are necessary to stimulate confidence in the strength of the Singapore dollar and the economy, such surpluses coexist with overborrowing and overall public sector deficits. The dilemma lies in how the government strikes a balance between maintaining surpluses and raising revenue to meet the overall deficits. The task is not an easy one as the optimum balance cannot be objectively and methodically fixed.

The financial model in Singapore thus features three basic ingredients; namely, a strong and development-oriented leadership, a diligent, productive people and a financial system which enables the transfer or flow of funds intermediated by the public sector; all bound by a determined survival instinct. This study also appears to substantiate a claim made by Dr. Goh Keng Swee who said:

> . . . in a country like Singapore which has no natural resources, the type of government that is elected to power is probably the most important single determinant of whether the country prospers or declines.[22]

He implies that in the Singapore context which lacks the natural resources to provide the engine for growth, the most vital ingredient is an able leadership which will chart and steer the economic course to maximize opportunities for growth. To do this, an available pool or available sources of finance to transform the economy from an entrepôt centre to a manufacturing-transportation-services centre is required. To this extent, the leadership ingredient appears to have emulated itself in obtaining and mobilising these funds.

But having seen Singapore through a "from rags-to-riches" transformation, the present leadership is concerned about both a capable and trustworthy core of leaders who will continue to lead effectively, as well as the general mass who will heed and respond to the PAP style of government, witness respectively the proposal to amend the Constitution to protect foreign reserves and the reminders to people to vote wisely and to get their basics about earning a living and ensuring prosperity right.[23] Yet, there may be a point at which people's tolerance for thrift-inculcating habits or for regulated centralized behaviour develops diminishing marginal returns. The authority has been made conscious of this subterranean force by the Howe report.[24] If this crucial point can be recognised in time and that time is also appropriate for some "letting go", there need not be any disruptive crisis to mar the 25 years of nation-building. The spread of home ownership and, generally, of wealth through CPF increases which follow CDP increases, has been a successful formula for both sociopolitical as well as financing implications as there is convergence of private and governmental desires. However, with the current 50% CPF contribution rate in the context of a tight, high wage labour market, a more affluent and politically conscious, home-owning electorate and imminent rejuvenation of leadership within the PAP, the scenario is changing.

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[22] His opening speech at a seminar on "Democracy and Communism", sponsored by the Ministry of Education for pre-university students on 24-29 April 1971. Reprinted in his *The Economics of Modernisation and Other Essays* (Singapore: Asia Pacific Press, 1972), p. 8. He has also identified the following reasons for Singapore's success, namely a) superb central geographical location with a natural harbour; b) government policy; c) nurturing free enterprise and d) continuous rapid growth in the region. The second and third features reflect the leadership's hand in the success story. See his "Why Singapore Succeeds", in *The Practice of Economic Growth* (Singapore: Federal Publications (S) Pte Ltd., 1977), pp. 1-2.

[23] *Straits Times*, 16 April 1984, 17 August 1984 and 20 August 1984.

[24] Singapore Ministry of Health *Report of the Committee on the Problems of the Aged*, under the Chairmanship Howe Yoon Chong, February 1984. The most explosive recommendation of this report was that the CPF withdrawal age be postponed from 55 to 60 in the first instance, and later to 65.

PEOPLE'S REPUBLIC OF KOREA:

New Joint Venture Law

On 8 September 1984 the Standing Committee of the Supreme People's Assembly of the People's Republic of Korea passed a joint venture law which could be the first move towards a more open economy. Up to now North Korea has followed a rigid policy of self reliance but it may now try to modernize its industry through cooperation with other countries, possibly also non-communist countries.

The following is an unofficial translation of the text of the new joint venture law.

LAW OF JOINT VENTURE OF THE DEMOCRATIC PEOPLE'S REPUBLIC OF KOREA

CHAPTER 1
BASIS OF JOINT VENTURE

Article 1. It is a consistent external economic policy of the Workers' Party of Korea and the government of the Republic to expand and develop economic and technical interchange and co-operation with many countries of the world.

The DPRK encourages joint ventures between its companies and enterprises with Foreign Companies, enterprises and individuals within its boundaries on the principle of equality and reciprocity.

Article 2. Joint ventures in the DPRK may involve many fields including industry, construction, transportation, science and technology, and tourism.

Article 3. The DPRK protects by law the properties invested by foreign parties in joint ventures and income accruing from the operation of such enterprises.

Article 4. The DPRK guarantees all legal rights stipulated by its law in connection with the management activities of the parties to a joint venture.

The joint companies should respect and strictly observe the legal norms and regulations of the Democratic People's Republic of Korea in all their activities.

Article 5. Koreans overseas including Korean traders and manufacturers in Japan may participate in joint ventures with companies and enterprises of our country under this law.

CHAPTER 2
ORGANISATION OF JOINT COMPANIES

Article 6. A joint company is organised when the parties concerned sign a contract and have it registered in the competent organ after getting endorsement of the external economic organ of the DPRK.

Article 7. The share of investment in the joint company is decided by agreement between the parties concerned.

The parties to a joint venture may make investments in the form of property in currency, property in kind, invention rights, technical documentation, etc.

In case of investment in the form of property in kind, invention rights, technical documentation, etc. prices are set by the parties to the joint venture according to international market prices.

Article 8. For the debts incurred by a joint company in the course of running it, the parties assume responsibility only for the size of their shares of investment.

If a party to a joint company wants to transfer his share of investment to a third party, it should get the consent of the other party.

Article 9. A joint company cannot reduce the fund registered.

CHAPTER 3
COUNCIL AND MANAGEMENT ACTIVITY

Article 10. A joint company has a council, which will be the highest deciding body.

A joint company has statutes which govern its management.

Article 11. The Council discusses and decides upon such important questions of the joint company as the adoption of its statutes and amendments and supplements thereto measures for the development of the joint company, plan of management, account settlement and division of income, appointment and dismissal of management staff and appointment of financial inspector.

Article 12. The director of the company organizes and manages it in conformance with the contract organizing the company, the statutes and the decisions of the council, to which he is answerable.

Article 13. A joint company may open its account with a bank of the DPRK or at a bank of another country by agreement between the parties to the joint venture.

It may seek a loan from a foreign bank for its operation.

Article 14. When a joint company buys raw and other materials, semi-finished goods, etc. needed for production in the DPRK, their prices are set in accordance with international market prices.

When a joint company imports goods from foreign markets, it does not pay a tariff.

Article 15. A joint company may export its products to foreign markets.

Article 16. When a joint company employs and discharges employees, it controls and uses the labour force in accordance with the law of the DPRK and the contract between the two parties to the joint venture.

Article 17. The foreigners working at a joint company should pay income tax in the DPRK.

The foreigners working at a joint company may remit part of their wages abroad.

CHAPTER 4
THE ACCOUNT SETTLEMENT AND INCOME DIVISION

Article 18. A joint company should regularly settle the accounts of its management once every year.

The account settlement is done in such a manner as to divide, according to the sizes of investment of the two parties to the joint venture, what remains after compensating the production costs, paying the income tax and deducting the reserve fund and the fund for the expansion of production and technical development and other necessary funds out of its total income.

Article 19. A joint company should create a reserve fund.

The size of the reserve fund and its annual rate are set specially.

The reserve fund is used for filling the deficit of the joint company.

Article 20. The document of account settlement of a joint company should be examined by the financial inspector and endorsed by the council.

Article 21. A joint company should pay income tax according to the DPRK Law on income tax of joint companies for the net income at each period of account settlement.

A joint company may be exempted from income tax for a certain period from the start of production.

In case the net income of a joint company is small, it may submit a petition for the reduction of income tax.

A joint company should pay the land tax when it uses land.

Article 22. The foreign party to a joint venture may remit its dividends abroad.

CHAPTER 5
DISSOLUTION OF JOINT COMPANIES AND SETTLEMENT OF DISPUTES

Article 23. A joint company is dissolved on expiration of the period of its existence stipulated in the contract.

If the parties to a joint company want to continue it, they should make a request to the competent organ six months before the termination of the period of its existence.

Article 24. When a joint company suffers continued deficits or when a contracting party fails to honour its duty or when the company cannot be operated due to unavoidable circumstances, it may be dissolved before the termination of the period of its existence by decision of the council.

Article 25. When a joint company is dissolved, the property remaining after the close of the business shall be divided between the contracting parties according to the size of their investment.

Article 26. Differences arising in the course of the operation of a joint company are solved by agreement.

The problems of disputes not resolvable by agreement shall be settled by a court or arbitration organ of the DPRK.

The examination of disputes may be tendered to the arbitration organ of a third country by agreement between the two parties.

KENYA:

The Taxation of Oil Companies

By M.E.C. Taylor

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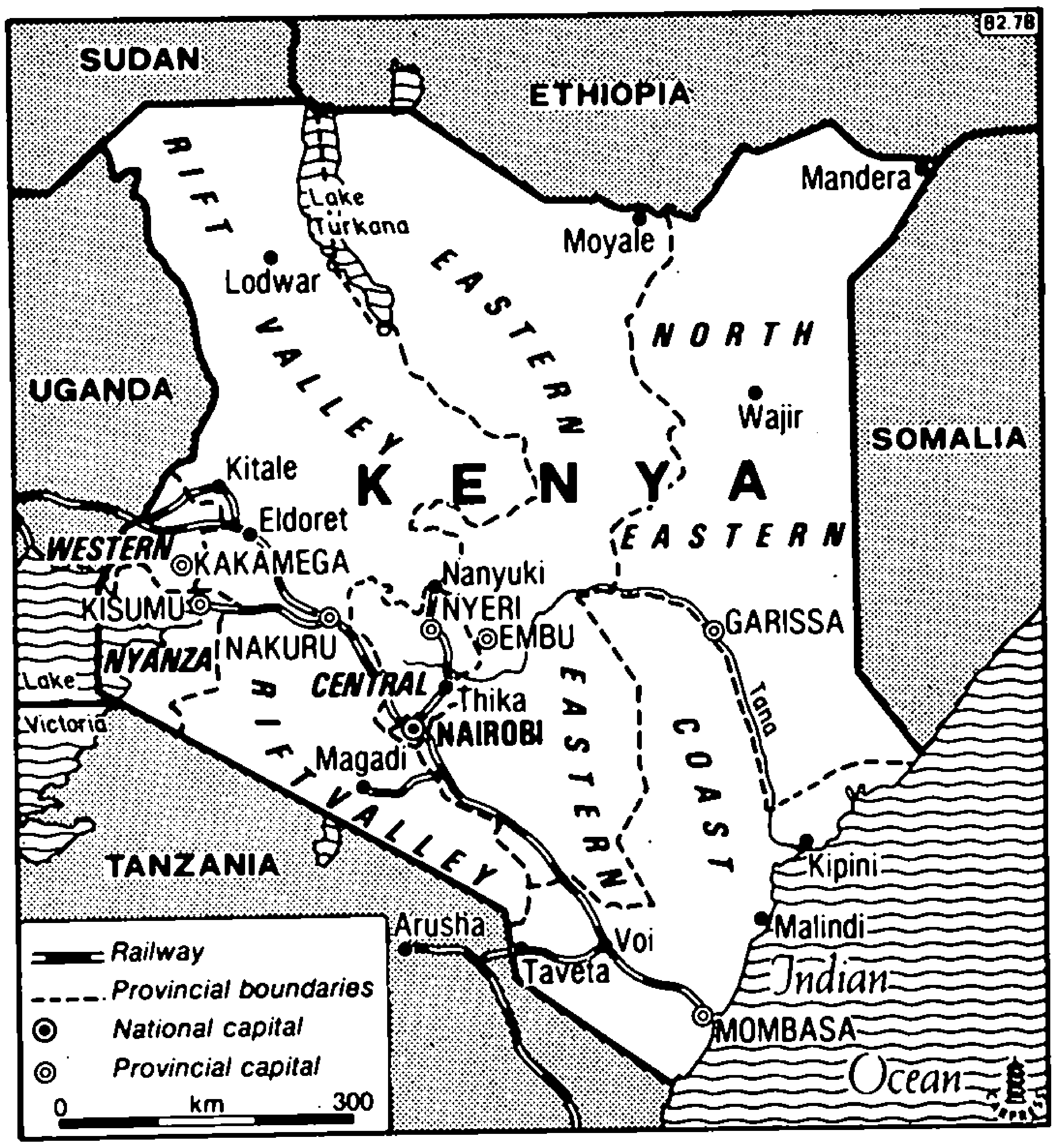
In recent years and especially in 1984 Kenya has seen renewed activity and interest in the oil exploration field. This has resulted in two Acts being passed through parliament in the latter months of 1984 to regulate the activities of the Oil Exploration and Producing Companies and to tax such companies on income derived from Kenya.

This article outlines the salient features of the Oil Exploration and Production Act 1984 together with its attendant Regulations and the specific taxation changes which have been incorporated in the Income Tax Amendment Act 1984.

THE OIL EXPLORATION AND PRODUCTION ACT, 1984

The Act provides the commercial framework within which Oil Companies are permitted to explore for and produce oil and gas. The Act outlines briefly the role of the Government in awarding licences. The detailed operations are contained in the Oil Exploration and Production Regulations which have already been issued.

The Government, as will be appreciated, has a significant interest in assisting the development of the oil industry within Kenya. At the same time, it wishes, in common with most Governments, to obtain as much financial and economic reward for the country as possible whilst allowing the oil companies a reasonable return on their investment. There obviously are a number of different ways in which this can be achieved. The method selected by the Government is a production sharing contract. Under this basis, the oil company incurs all the exploration costs and pays a few modest fees to the Government.



When a commercial discovery is made, out of which its investment can be recovered, the proceeds of oil are divided into "cost oil" and "profit oil". The oil company takes the "cost oil" to reimburse itself for all its current operating costs plus 20% of its exploration costs and development costs over the first years of production.

Any balance of the value of the "cost oil" in excess of the formula becomes "profit oil". Profit oil is shared between the oil companies and the Government on a scale which escalates in favour of the Government. Out of the Government's share of profit oil comes the Income

Tax which would normally be payable by the oil company on its profits. Figures, as to the split between cost and profit oil and the division of profit oil between the Government and the oil company, are not yet available.

THE DETAILED REGULATIONS

The Regulations are structured in the form of a draft model production sharing contract. The contract provides for the terms of a licence, rights and obligations of the contractor, rights and the obligations of the Government, detailed working arrangements, books and records and Government participation.

Terms and conditions

The exploration licence is granted for an unspecified number of years, although this would normally be five years renewable. The contract calls for a minimum level of expenditure and also contains the normal provision, that at the end of the period of the exploration licence, a percentage of the block, normally one half, will be surrendered back to the Government.

Obligations of the contractor

Most of the provisions contained in this section of the Regulations require the contractor to use his skills in conformity with the best international oil company practice to conduct operations efficiently. The Regulations make it clear that most of the blocks are not exclusive, i.e. the Government is in a position to grant other oil companies the right to perform seismic work although not to drill. There is a general obligation on the contractor to cause the minimum amount of disruption to land or sea areas in his operations and, if his operations cause damage to land owned by private individuals, to pay prompt and fair compensation. There are various obligations, which run throughout the Regulations, to make regular and full reports to the Government concerning virtually every area of his operations.

Rights and obligations of the Government

The Government is entitled to prohibit the contractor from operations in any part of the block "in the public interest" although it may permit directional drilling from another part of the block under such land.

The Government, on the other hand, will assist the oil companies in obtaining rights of access to trust land and to issuing such compulsory purchase orders as may be necessary to allow the oil company to conduct its operations. The Government may also grant the contractor rights of temporary occupation within the block which may be necessary to allow pipelines etc. to be laid.

Development

The Regulations contain more detailed rules concerning the formulation of a development plan for a commercial discovery and the information required to be supplied to the Government. The Government has the power to approve or reject any development plan.

Government participation

The Government has the right to buy into a commercial discovery when a field is proved to be commercial. The percentage of participation is not expressed in the Regulations. If the Government exercises its option, which must be done shortly after the development plan is adopted, it must reimburse the oil company for its share of expenditure to date.

The Regulations also make it clear that the oil company must supply, at the direction of the Government, oil to the domestic market in preference to export.

Accounting and auditing considerations

The Government maintains the right to audit the operator's books at any time. This is a Government cost. Alternatively, at the request of the Minister, the oil companies must appoint an independent auditor of international standing, approved by the Government, to annually audit the books and accounts of the contractor and to report thereon. The cost of such audits shall be borne by the contractor.

The books must be kept in U.S. dollars and it is intended that no gain or loss on exchange would adversely effect either the Government or the oil company. Any such expenses or income are for the account of the project.

Miscellaneous provisions

The oil companies are given a wide measure of exemption from import duties and sale taxes. However, any goods imported into Kenya which are subsequently disposed of in the country after their use in oil exploration will be subject to duty.

The oil companies are to be automatically granted Certificates of Approved Enterprise for their investment in Kenya. The amounts recognised by the certificates will be the actual amount invested provided that the oil company will not be entitled to repatriate any proceeds of sale of an asset which forms part of either of qualifying expenditure under the Income Tax Act or an asset which is specifically subject to a Certificate of Approved Enterprise.

THE INCOME TAX AMENDMENT ACT (1984)

In summary the Amendment Act provides for a Ninth Schedule which governs the taxation of oil companies and makes a few consequential amendments to the main Act.

It should be noted that this does not affect the tax position of existing oil marketing companies in Kenya and will not do so unless, which is unlikely, the oil companies incorporate their exploration and production activities into the same corporate entity.

Income from oil activities is to be regarded as a separate source of income for tax purposes. Income and expenditure will have to be calculated separately from other sources of income (normally only interest) and a loss in oil operations will not be eligible for offset against other sources of income.

The Oil Exploration and Production Regulations provide that oil companies must file their final tax returns four months after the end of the fiscal year. It is assumed that provisional tax returns will have to be filed by the end of the third month after the fiscal year, as is the case with other companies.

Determination of income

In determining the gross income of an oil company, certain rules are laid down both in the Regulations and in the Act for arm's length valuations of petroleum and natural gas. The normal difficulty in this area is the valuation of oil or gas used by the contractor in his own work.

Deduction for expenditure

As far as the deduction of expenditure is concerned, the Act lays down the following broad rules:

(a) Immediate deductions for the following:
  (i) intangible drilling costs;
  (ii) geological and geophysical costs;
  (iii) payments to the Government under the terms of the licence;
  (iv) recurrent production expenditure;
  (v) executive and general administrative expenses incurred in Kenya.

(b) If an oil company operates through a branch, reasonable executive and general administrative expenses carried on outside Kenya, including management and/or professional fees, can be deducted.

(c) Management or professional fees paid directly by the branch including those paid overseas are deductible.

(d) Interest is deductible, including interest paid by a non-resident and "fairly and reasonably allocated to a permanent establishment", provided that the interest is at an arm's length rate, the loan is applied for petroleum operations in Kenya and withholding tax is deducted if paid to a non-resident.

(e) Qualifying expenditure, which is defined as plant, machinery, pipelines, rigs, industrial buildings, licence rights and other expenditure incurred in searching for, discovering and testing petroleum deposits or gaining access thereto, is deducted on a 20% straight line basis over five years. The first qualifying year is the year in which production commences or the year in which the expenditure is incurred, whichever is the later.

Withholding tax

The Act provides that where management fees are paid to a non-resident by an oil company, the rate of withholding tax will be 12.5%. Similarly withholding tax on interest paid to a non-resident will be 10%.

If the oil company operates as a local company, no withholding tax is applied to dividends paid to non-residents out of profits from oil activities.

Farm-outs

It is common practice for an interest in the licence to be assigned or sold by one company to another. The Act taxes farm-outs on a fairly simple basis. Any money received by the seller is regarded as income rather than capital gain. To the extent that this represents the reimbursement of "qualifying expenditure" the residue of any qualifying expenditure will be allowed as a deduction from the sales proceeds thus effectively giving rise to a balancing charge. It is assumed that the incoming party will be allowed to treat whatever he pays for qualifying expenditure as the full amount which is entitled for deduction.

THE TAXATION OF OIL SERVICE SUB-CONTRACTORS

The Act incorporates simple rules for the taxation of non-resident sub-contractors who are appointed by the oil companies in exploration operations. The sub-contractors are to be taxed on a "deemed profits" percentage of 15% to which the normal branch tax rate of 52.5% applies.

This assumed profit rate shall be applied to all moneys paid by an oil company to a petroleum service sub-contractor, referred to as the "taxable service fee" but excluding:

(a) moneys actually paid by an oil company to reimburse the petroleum service sub-contractor for the cost of mobilisation and where applicable, demobilisation; and

(b) reimbursement of expenses.

Payment for mobilisation and demobilisation shall not exceed the amounts normally paid in the international petroleum industry, having regard to the circumstances of the contract, and shall not be at a level calculated to transfer a part of the taxable service fee to the non-taxable moneys referred to in (a) above.

"Mobilisation" and "demobilisation" means the movement of men and equipment to Kenya prior to operating, and from Kenya after completion thereof, provided the movement is not to a third party, but does not include the movement of men and equipment in Kenya during operations.

"Reimbursement of expenses" means payment by an oil company to a petroleum service sub-contractor to reimburse that sub-contractor for payments made to a third party on behalf of the oil company in respect of goods and services which are incidental to the sub-contract and would not normally, in the international petroleum industry, be included in the taxable service fee, but does not include a charge for handling or administration.

The Act further states that no payment shall be made by or on behalf of an oil company to a petroleum service sub-contractor unless the petroleum service sub-contractor has issued an invoice for services rendered, and the Act provides that distinct and separate invoices should be issued by the petroleum service sub-contractor to the petroleum company in respect of:

(a) the taxable service fee,
(b) the amounts payable for mobilisation and demobilisation, and
(c) the reimbursement of expenses.

The invoice for reimbursement of expenses should have attached to it copies of the invoice to which it relates.

When paying a taxable service fee the oil company shall:

(a) deduct an amount of tax equal to 52.5% multiplied by the assumed profit;
(b) issue to the petroleum service sub-contractor a certificate showing the gross amount of the invoice, the amount deducted for tax and the net amount payable; and
(c) retain a copy of the invoice and certificate for a period of three years.

Returns

The Act imposes certain obligations on the oil companies as to the filing of returns with the Income Tax Department.

It provides that the tax collected by an oil company in any month shall be remitted within thirty days to the Commissioner with a return of amounts paid and tax deducted. Such returns are termed the "sub-contractor's return" and should show in respect of the month the following details:

(a) the total taxable service fee paid;
(b) the total tax deducted and remitted;
(c) the total amount paid for mobilisation and demobilisation; and
(d) the total amount paid for reimbursement of expenses.

Before making a first payment to a petroleum service sub-contractor, an oil company will have to deliver to the Commissioner a summary of the terms of the contract with that sub-contractor including the terms and rates for operating, mobilisation and demobilisation and reimbursement of expenses, and shall deliver a summary of any change in those terms within 14 days of any such change.

Maintenance of records

The Act provides that the oil company will have to keep up-to-date records, referenced to the invoices of the petroleum service sub-contractor and agreeing with the sub-contractor's return available for inspection at all reasonable times by the Commissioner and showing in respect of each payment made to a petroleum service sub-contractor the following information:

(a) the name and address of the sub-contractor and the services provided;
(b) the date and the amount of the invoices from the petroleum service sub-contractor;
(c) the tax deducted; and
(d) the monthly total of the tax deducted and remitted to the Commissioner.

In next issues:

India: Budget 1985-86 – by *Kailash C. Khanna*

The E.C. Commission on income taxation and equal treatment for men and women

Statement on the OECD Report of 6 July 1982 by the *Institut der Wirtschaftsprüfer (IDW)*

Thailand: New withholding taxes – by *Montri Hongskrailers*

Fiscal system and economic development: The Asian case – by *Mukul G. Asher*

The 1985 income tax changes in the Republic of South Africa – by *Dr. Erwin Spiro*

Republic of South Africa: Budget 1985-86

Guinea: New investment code – by *Servaas van Thiel*

MEXICO:

Income Tax on Gifts

By M.A. Gª Caballero

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In the February 1985 issue of the *Bulletin for international fiscal documentation* a survey of inheritance and gift taxes in the Latin American countries was published.[1] However, the mere fact that no inheritance tax or gift tax as such is levied in a country does not always mean that transfer of property by death or as a gift will not be taxed, since in certain cases capital gains tax, stamp tax or property transfer tax may be due.[2]

This note focusses on the imposition of *income tax* on certain gifts in Mexico. In our previous article we stated:[3]

> In Mexico, there is no inheritance (estate) or gift tax levied either at federal or local level. The former federal tax on inheritances and bequests (Ley Federal del Impuesto sobre Herencias y Legados) was abolished at the federal level and for the Federal District by a law of 1 January 1962; and the former federal tax on gifts (Ley Federal del Impuesto sobre Donaciones) was abolished at the federal level and for the Federal District by a law of 1 January 1964. The other 30 states of the federation also abolished their respective inheritance and gift taxes. Moreover, the tax on acquisitions of real property and rights thereon, whether for consideration or gratuitously (i.e. by inheritance, bequest or gift), is not a substitute inheritance and gift tax, but a tax which was substituted for the former stamp tax law of 24 December 1975 with effects as from 1 January 1980. Therefore, inheritances and gifts are not subject to any tax in Mexico.

Nevertheless, by virtue of Arts. 74, 77 (xxiv), 150 and 151 of the Income Tax Law[4] (as amended) certain gifts may be treated as income where received by an individual donee. However, gifts made to the donor's spouse or direct ascendants or descendants are exempt from income tax. The current situation may be summarized as follows:

1. Gifts exempt from personal income tax

These are:

- gifts of any kind where the recipient (whether resident in Mexico or abroad) is the donor's spouse, a direct descendant or ascendant;
- with respect to other recipients:
  - gifts of any kind provided he/she is a resident of Mexico in an amount not exceeding 3 times the annual minimum salary applicable in the economic zone where he/she lives;
  - gifts in cash or in kind (other than Mexican-situs real property, shares and other capital participations)[5] where the recipient is a non-resident of Mexico.

2. Gifts subject to personal income tax

A distinction is made between resident and non-resident recipients:

Residents

Gifts of any kind received by a donee (provided he/she is not the donor's spouse, direct descendant or ascendant) must be included in the donee's taxable income in the amount by which the aggregate amount of gifts received in a calendar year exceeds the tax-free limit indicated above. Accordingly, a no-exempt donee living in the following cities will, in 1985, be subject to income tax on the excess over the amounts stated below (i.e. the daily minimum wage x 365 x 3):

- Mexico City : 1,160,700 pesos
- Monterrey : 1,067,625 pesos
- Merida : 941,700 pesos
- Oaxaca : 854,100 pesos

Non-residents

Gifts of Mexican-situs real property, shares and capital participations received by a donee (other than the donor's spouse, direct descendants or ascendants) are subject to income tax at a flat rate of 20% on the officially appraised value of such property (no deductions are granted).

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[1] Caballero, M.A. Gª: "Latin America: Taxation of gifts and inheritances – A practical approach" in 28 *Bulletin for international fiscal documentation* 2 (1985) at 55.

[2] This is, for instance, the case in Colombia (capital gains tax); Costa Rica (real property transfer tax and education and culture stamp duty).

[3] Note 1, at 69.

[4] Published in the Official Gazette of 30 December 1980.

[5] Shares or participations in Mexican companies.

UNITED KINGDOM:

Budget 1985-86: Further Reform

Extracts from the Budget Speech pronounced by the Chancellor of the Exchequer on 19 March 1985.

Tax reform

This Budget carries forward the theme of tax reform I set out last year – reform designed to make life a little simpler for the taxpayer. And above all reform designed to improve our economic performance over the longer term, on which the jobs of the future will depend.

In my Budget last year I announced a radical reform of the Corporation Tax system. This had been preceded by the Green Paper on Corporation Tax issued by my predecessor in 1982.

I am satisfied that the right way to proceed with major tax reform is to issue a Green Paper first, as a basis for full and informed discussion followed by legislation when the results of that discussion have been fully digested.

I therefore propose to issue a Green Paper later this year on the reform of personal income tax.

The computerisation of P.A.Y.E. makes this the right time to review the system of personal taxation. Most of the work will be complete by the end of 1987 and the full range of facilities will be available by 1989. The Green Paper will therefore discuss a range of options opened up by computerisation from non-cumulation to closer integration between the tax and benefit systems, and including in particular a reform of the present system of personal allowances.

It is the Government's firm policy to reduce the burden of income tax. But we need to make sure that the reliefs we can afford are concentrated where they do most good. The present structure of personal income tax is far from satisfactory. Too many young people start paying tax at too low a level and too many families find themselves in the poverty and unemployment traps. The system discriminates against the family in which the wife stays at home to look after the children. It denies to the partners in a marriage the independence and privacy in their tax affairs which they have a right to expect.

There is therefore a strong case for changing to a new system of personal allowances more suited to today's economic and social needs. Under this, everyone, man or woman, married or single, would have the same standard allowance. But if either a wife or a husband were unable to make full use of their allowance, the unused portion could be transferred, if they so wished, to their partner.

This reform would produce a more logical and straightforward system. Far more people could be taken out of the poverty and unemployment traps, and indeed taken out of tax altogether, for a given sum of overall tax relief than is possible under the present system. It would end the present discrimination against the family where the wife feels it right to stay at home, which increasingly nowadays means discrimination against the family with young children.

Husbands and wives would each be taxed separately on their own income, irrespective of the income of the other. The aggregation for tax purposes of a wife's earned income and investment income with her husband's would end, thus removing what has become an increasing source of resentment among women.

Pension funds

The Green Paper will set out full details of the proposals I have just outlined, as a basis for public discussion. After an appropriate period for consultation, it would be possible to legislate in 1987 and have a system on these lines in place by the end of the decade.

There is also a case for changing the tax treatment of pension funds, as part of a thoroughgoing reform of the tax treatment of personal savings generally. Any fundamental reform of this kind would, in the same way, need to be preceded by the publication of a Green Paper.

The House will, I am sure, be interested to learn that I have no such Green Paper in mind. Nor, indeed, despite the unparallelled pre-Budget agitation, do any of the detailed proposals in my Budget affect the tax-deductibility of pension fund contribution, the tax-free nature of pension fund income and capital gains, or the anomalous but much-loved tax-free lump sum.

Meanwhile, I have a number of other important proposals for tax reform to announce today, which will both simplify the system and encourage enterprise.

Capital gains: abolition of 12-month rule

First, Capital Gains Tax. Last year I was unable to do anything about the acknowledged defects of this tax, notably its combination of unfairness and complexity, and undertook to come back to it this year.

This I now do.

I have decided that the right way to reform Capital Gains Tax is to build on the important change made by my predecessor three years ago, when he introduced the 1982 indexation relief.

That relief, valuable though it is, and increasingly valuable as it will become, suffers from three serious limitations.

First, indexation does not cover the first 12 months of the ownership of an asset. This provision was introduced to discourage the short term conversion of income into capital. But it has made the tax very much more complicated for the taxpayer. I am now in a position to remedy this defect. Hon Members will recall that I announced last month measures to put an end to the practice known as bondwashing, the principal device for converting income into less heavily taxed capital gains. Having done that, I propose to abolish the 12-month rule. So far as most disposals are concerned, this will take effect from April 6. In the case of certain fixed interest securities, however, the rule will need to remain in being until the anti-bondwashing provisions take effect on February 28, 1986.

Second, the indexation does not at present extend to losses. I propose to remove this restriction.

Third, the present indexation provision unfairly discriminates against those who acquired their assets prior to 1982. For them the allowance is based not on the 1982 value of the asset but on its original cost. I now propose to remedy this injustice. The indexation allowance will henceforth be based on March 1982 values. Capital gains made prior to 1982 will still not be indexed, of course, but at least all purely inflationary gains made since that date will now be free of tax, irrespective of when the asset was acquired.

This three-pronged reform of Capital Gains Tax will produce a fairer tax, make life simpler for the taxpayer, help the efficient working of the capital markets, relieve the burden on family businesses and encourage risk-taking and enterprise. Combined with the statutory indexation of the exempt amount, which will rise in 1985-86 to £ 5,900, these changes will remove some 15,000 taxpayers from liability altogether.

Increasingly the tax will be levied on real and not inflationary gains. With these reforms, I believe the tax is now on a broadly acceptable and sustainable basis.

The combined cost of the threefold reform I have announced is £ 155m in a full year, but none of it falls in 1985-86.

Stamp duties: modernization

I turn next to the stamp duties.

Following widespread consultation, I have decided that the time has come to simplify and modernise these ancient duties. I propose in this Budget to sweep away 15 separate duties, including the contract note duty and the 1% duty on gifts. Altogether, the changes I am proposing should reduce by over 40% the number of documents which require to be stamped.

Development Land Tax: abolition

My final proposal for reform concerns Development Land Tax.

This is a particularly complex tax, which was introduced in response to the problem of soaring land values at a time of high inflation. Its chief practical effect is to discourage the bringing forward of land for development. This disincentive effect will grow as the gap widens between the 60% rate of Development Land Tax and a Corporation Tax rate which is on the way down to 35%.

I have therefore decided to abolish Development Land Tax altogether, with immediate effect. At the same time I propose to cancel all deferred charges under the tax. The net cost will be some £ 20m in 1985-1986 and £ 50m in a full year. This compares, incidentally, with a collection cost of some £ 5m a year. Development gains will of course continue to be subject to income tax, Corporation Tax and Capital Gains Tax, in the same way as any other income or capital gains.

The abolition of development land tax will, I am sure, be especially welcomed by the building and construction industry. It will also remove no fewer than 200 pages of highly complex legislation from the statute book.

This follows the abolition of the National Insurance Surcharge and the Investment Income Surcharge in last year's Budget. Three unwanted taxes swept away in two years.

Scientific research

I now turn to other aspects of business taxation. It cannot be repeated too often that it is businesses and not Governments that create jobs. The Government's responsibility is to foster the conditions which will encourage businesses to grow and create more jobs. The measures I have to announce are designed with that end in view.

First, corporation tax. The reforms I announced last year set out a new and improved framework of business taxation for the remainder of this parliament and beyond. So this year, I have only limited changes to make. A full list is of course contained in the Red Book.

As I promised last year, I have reviewed the Scientific Research Allowance. Given the particular importance of expenditure on research and development if British industry is to hold its own in a competitive world. I have decided, exceptionally, not to reduce this allowance in line with the changes in the other capital allowances. A few minor changes apart, the Scientific Research Allowance will remain at 100%.

Short life assets

I have also decided to modify the new capital allowance system as it applies to short life assets. While the new structure of capital allowances enables most plant and machinery to be written off over a period that more than fairly reflects its useful life, I accept that there is a problem with those assets which enjoy only a short life, in particular high technology assets.

Accordingly, from next year, a business will be able to exclude from its general pool of capital expenditure any assets which it believes will have only a short life; so that if the asset is subsequently scrapped after, say, four years, it will be fully written off for tax over that period. I believe that this change will be widely welcomed. The benefit to business could rise to about £ 300m in the early 1990s.

Profit sharing schemes

I now turn to a number of other detailed measures affecting business.

The number of employee share schemes has increased from 30 when we first took office in 1979 to some 850 today. The wholehearted commitment of employees to the success of the companies in which they work is vital to our country's economic future. To maintain and build on this progress, I propose to reduce the retention period for profit sharing schemes from seven years to five.

Partnerships

I propose to take action to deal with tax avoidance by partnerships, following the consultative document issued last year.

VAT: imported goods

In my last Budget I removed a competitive disadvantage to British manufacturers by levying VAT on imports. I have decided to modify the new regime in two respects.

First, I propose to relieve from VAT certain goods which are imported into this country solely for repair, or for processing which does not change their identity, and are then re-exported to their owners overseas. Second, goods which are temporarily exported from the U.K. and then reimported after repair or processing abroad, will bear VAT only on the value of the repair or processing. These reliefs will take effect on June 1 and have a once-for-all cost in 1985-86 of £ 30m.

Short-term securities

I propose to introduce secondary legislation to remove the constraint imposed by the Banking Act which at present prevents companies from financing themselves by a series of issues of short-term securities. This should provide a useful alternative to bank borrowing.

North Sea oil

I have no major new proposals this year on the taxation of North Sea oil. I have reviewed the economics of incremental investment in existing fields, but I have not been persuaded that there is a case for introducing new fiscal reliefs at this stage. My only proposal for change, apart from some minor technical measures, is to remove immediate Petroleum Revenue Tax relief for onshore exploration and appraisal expenditure. Onshore activities are sufficiently low-cost not to need this special incentive.

U.S. unitary taxation

In last year's Budget statement I mentioned the Government's concern at the spread of unitary taxation within the United States, and the threat that this posed to the U.S. subsidiaries of British companies. Since then, I am glad to note that several American States have abolished unitary taxation, but in others, notably California, no change has yet been made. We shall continue to press for action to be taken this year, and fully support the campaign being waged by the CBI and others on this issue.

Small businesses and self-employed

Finally, I turn to a group of measures of particular importance to smaller businesses and the self-employed, a sector of the economy where an increasing proportion of the jobs of the future is likely to be found.

I have already announced a substantial reform of the Capital Gains Tax. In addition, I propose to implement many of the proposals contained in last year's consultative document on Capital Gains Tax retirement relief, notably to reduce the age of full relief to 60 and to extend relief to those who are obliged by ill-health to retire before that age. This relief is particularly important to the proprietors of small businesses concerned at the Capital Gains Tax they might have to pay when they come to sell their business on retirement.

Although the Business Expansion Scheme has been in existence only two years, it has already made an impressive contribution to the promotion and growth of new businessess. Last year almost 20,000 people took advantage of the tax reliefs offered by the Business Expansion Scheme to invest some £ 100m in more than 500 companies. Over half of this went to provide equity capital for new businesses.

I have two changes to propose. The scheme was designed to encourage investment by individuals in new and expanding businesses in risk areas. Accordingly, I propose to include within the scheme companies formed to carry out research and development. By the same token I propose to exclude from the scheme certain ventures which primarily involve property development. Building and construction will, of course, continue to be a qualifying trade.

Last year I undertook to review the scope of VAT relief for bad debts, a matter of considerable concern to small businesses. In the light of legislation now proceeding in another place on the reform of the insolvency law, I propose to widen the scope of the existing relief. The new rules will take effect as soon as the provisions of the Insolvency Bill are implemented and will cost some £ 25m in a full year.

I propose to increase the VAT threshold to £ 19,000 from midnight tonight.

Over the past five years, the ranks of the self-employed have risen by well over half a million or some 30% and the growth in self-employed has been a particularly marked feature of the encouraging growth in overall employment that has occurred since the spring of 1983.

But the self-employed suffer from one long-standing grievance so far as tax is concerned. While the National Insurance contribution paid by an employee cannot be set against tax, the National Insurance contribution paid by the employer on the employee's behalf can. Yet none of the National Insurance contribution paid by the self-employed can be set against tax at all.

Today, I propose to remedy this grievance. As from April 6, tax relief will be allowed for half the graduated Class 4 National Insurance contribution paid by the self-employed. In addition, I have agreed with my Right Hon Friend the Secretary of State for Social Services that, as from the beginning of October, the flat rate Class 2 National Insurance contribution payable by the self-employed will be reduced from £ 4.75 to £ 3.50 a week. The benefit of these reliefs to the self-employed will be £ 55m in 1985-86 and £ 155m in a full year.

All this adds up to a substantial package of measures to help small business and the self-employed, which I am sure the whole House will welcome.

Personal income and spending

I turn now to the taxation of personal income and spending. My Budget last year shifted some of the burden of personal taxation from earnings to spending. Today I propose to make a further move in this direction.

Accordingly, I propose to increase the revenue from the excise duties by rather more than is required simply to keep pace with inflation – a less painful task now that inflation is relatively low.

I propose to increase the duty on cigarettes and hand-rolling tobacco by the equivalent, including VAT, of sixpence on a packet of 20 cigarettes. This will take effect from midnight on Thursday. I do not, however, propose any increase at all in the duties on cigars and pipe tobacco.

I propose increases which, including VAT, will put between a penny and twopence a pint on most beer (depending on its strength); a penny a pint on cider, six pence on a bottle of table wine and about 10 pence a bottle on sparkling or fortified wine. In recognition of the current difficulties of the Scotch whisky industry, however, I propose to increase the duty on spirits by only 10 pence a bottle, well below the amount needed to keep pace with inflation. All these changes take effect from midnight tonight.

I propose to increase the duty on petrol and derv by amounts which, including VAT, will raise the price at the pumps by approximately four pence and 3½ pence a gallon respectively. This does no more than keep pace with inflation. These increases will take effect from 6 o'clock this evening. As last year, I do not propose any change in the duty on heavy fuel oil.

I do propose this year, however, to raise more revenue from the Vehicle Excise Duty. For cars and light vans the duty will go up by £ 10 to £ 100.

On the advice of my Rt Hon Friend the Secretary of State for Transport, the pattern of duty on lorries will be changed to correspond more closely to the amount of wear and tear they cause to the roads. While there will be substantial increases in duty for some of the heaviest rigid lorries, for most lorries the rates will remain unchanged.

These changes in the excise duties will, all told, raise an extra £ 820m in 1985-86, some £ 235m more than is required to keep pace with inflation. The overall impact effect on the RPI of these changes will be one half of 1%. This has already been taken into account in the forecast I have given the House of 5% inflation by the end of the year.

VAT: advertising and credit cards

I now turn to VAT.

I have followed with interest the speculation that has built up over recent months about my alleged intentions for VAT. Most of it – such as the so-called proposal to levy VAT on books – has concerned matters which have not even been under consideration. But to have revealed this prematurely would not have stilled speculation; it would merely have concentrated it on those matters that were under consideration – a practice that no chancellor, rightly, has sought to encourage.

I can now inform the House that, apart from one change I shall be proposing today I do not intend to make any further extensions of the VAT base during the lifetime of this parliament. This is, of course, a field in which European Community law has to be reckoned with and where we are bound by our treaty obligations. But as the House will be aware, where we are currently under challenge, we are vigorously fighting our case.

The one extension I propose to make concerns newspapers and magazines. At present, while all other advertising is taxed, newspaper and magazine advertising is not. There is no justificaton for this anomaly. It is one thing to maintain that newpapers and magazine should not be liable to VAT; quite another to argue that those who advertise in them should enjoy a similar immunity. Accordingly, I propose that from May 1 newspaper and magazines advertising should be subject to VAT. This will raise £ 30m in 1985-86 and £ 50m in a full year.

I also propose to change the VAT treatment of credit cards and similar payment cards – a part of the financial sector which has enjoyed exceptional growth over the past few years. I propose that from May 1 transactions between the companies providing the cards and the outlets which accept them should be classified as exempt. This means that the companies will not be able to recover VAT in respect of such transactions. This will raise £ 15m in 1985-86 and ƒ 20m in a full year. It should not directly affect the charges made to card holders.

I also have a modest VAT concession to make. I have decided to extend the existing VAT relief for medical or scientific equipment bought with donated funds for use in hospitals and the like to cover computer equipment for certain medical uses. Customs and Excise will be announcing the precise details of the relief, which will take effect from May 1.

Following extensive consultations, I propose to include in this year's Finance Bill legislation to implement most of the recommendations of the first two volumes of the Keith Report on the Enforcement Powers of the Revenue Departments, including measures to deal with the problem of the late payment of VAT. This is expected to bring in extra revenue of about £ 50m in 1985-86. By 1988-89 there will have been a cumulative once-for-all revenue gain of about £ 600m. Proposals on the Inland Revenue aspects of the Keith Report will follow in next year's Finance Bill.

The VAT changes I have just proposed will bring in £ 90m in 1985-86, rising eventually in £ 215m in a full year. They will have no impact on the RPI. The additional revenue raised from the excise duties and VAT taken together will help me to lighten the burden of income tax.

Capital Transfer Tax

Before turning to income tax, I should briefly mention Capital Transfer Tax. Since

1979 the burden of this tax has been very significantly reduced, and I propose to maintain that position this year by raising the threshold and rate bands set last year in line with statutory indexation. In addition, I propose to widen the scope of the existing exemption for amenity land surrounding a house of outstanding heritage quality. I am sure that this will be welcomed by all those concerned with the preservation of our national heritage.

Income tax

I now turn to income tax. On April 6, the banks will move over to the composite rate system for the payment of tax on bank interest. I now need to legislate to put the corresponding composite rate payments by building societies on a similar footing, starting next year. This will not produce any additional revenue. As an administrative saving, I also propose to legislate this year to bring new loans above the mortgage interest relief ceiling into the MIRAS system by April 1987. The ceiling itself will remain at £ 30,000 for 1985-86.

I need to set the 1986-87 car benefit scales for those whose employers provide them with the use of a car. As last year, I propose to increase both the car and fuel scales by 10% with effect from April 1986. This will still leave the scale levels as short of the true value of the benefit.

To give further help to charities, I propose to increase from £ 5,000 to £ 10,000 the limit to which relief at the higher rates of tax is allowed for covenants.

No change in rates

I now turn to my main income tax proposals.

I propose to make no change this year in the rates of income tax. Once again, I believe it is right to concentrate most of the limited resources at my disposal on raising the starting point for tax. Increases in the basic tax thresholds benefit all taxpayers, but they give proportionately more help to those on low incomes. This year, a Budget for jobs and for enterprise has to give high priority to raising the tax thresholds.

The statutory indexation formula means that I should increase all the principal income tax allowances and bands by 4.6%, the increase in the RPI over the year to last December, rounded up. For the higher rate thresholds and bands I propose this year to do just that. The first higher rate of 40% will be reached at a taxable income of £ 16,200 and the top rate of 60% will apply to taxable income above £ 40,200.

For the basic thresholds I can do more. Statutory indexation would imply an increase in the single person's allowance of £ 100. I propose to increase it by precisely twice as much – £ 200m – from £ 2,005 to £ 2,205. Statutory indexation would imply an increase in the married man's allowance of £ 150. Again, I propose to raise it by precisely twice as much – £ 300m – from £ 3,155 to £ 3,4555.

I propose to increase the age allowances this year by the same cash amount as the correspondong basic allowances. Thus the single age allowance will rise by £ 200 from £ 2,490 to £ 2,690 and the married age allowance will go up by £ 300 from £ 3,955 to £ 4,255.

These increases mean that most single people will enjoy an income tax cut of at least £ 1.15 a week and most married couples an income tax cut of at least £ 1.73 a week. **Some 800,000 people on low incomes – 100,000 of them widows – who would have paid tax if thresholds had not been increased, will pay no tax at all in 1985-86. That is almost twice as many as would have been taken out of tax had the allowances merely been indexed.**

The income tax changes I have annonced today will take effect under P.A.Y.E. on the first pay day after May 17. Their cost is considerable: £ 1.6bn in 1985-86, of which roughly half represents the cost of indexation.

The increase in the basic allowances of almost 10% or some 5% in real terms, means that for 1985-86 they will be more than 20% higher in real terms than they were in 1978-79, Labour's last year.

National insurance contributions

I have one last proposal to make.

I have already set out the broad lines of the Government's strategy to improve the prospects for jobs. I have described a number of measures to improve training, remove legislative barriers to employment, and stimulate enterprise; and I have also raised tax thresholds substantially for the second year running.

But I want to do more to improve job prospects for young people and the unskilled, among whom the problem of unemployment is most severe.

I have concluded that an effective response to this problem must include direct action in two related areas – to cut the costs of employing the young and unskilled and to sharpen their own incentive to work at wages which employers can afford to pay.

I am therefore proposing, in collaboration with my Rt Hon Friend the Secretary of State for Social Services, a radical reform of the structure of National Insurance contributions. The essential features of the contributory principle will be preserved.

The changes will affect both employers' and employees' contributions.

Given the limited resources at my disposal I cannot afford this year to make a further substantial reduction in the overall burden of employment costs, following the abolition of the National Surcharge in last year's Budget. I therefore propose to abolish the upper earnings limit for the employer's National Insurance contribution which for 1985-86 has been set at £ 265 a week.

Under existing arrangements, an employer pays in National Insurance the same cash sum, which for the coming year would be roughly £ 28 a week, for employees above the upper earnings limit, regardless of whether the employee is paid £ 15,000 a year or £ 50,000. Under the new and arguably fairer scheme I am now proposing, the employer's liability will be the same flat 10.45% of earnings as at present applies below the upper earnings limit.

The £ 800m raised by this change in a full year enables me to make a substantial reduction in the cost of employing people at the lower end of the earnings scale. There, instead of the uniform 10.45%, I propose to introduce a system of graduated rates.

As now, there will be no National Insurance payable for those earning below the lower earnings limit, which for 1985-1986 has been set at £ 35.00 a week broadly in line with the single person's pension. But for employees earning between this and £ 55 a week, the employer will in future have to pay only 5% instead of 10.45%; for employees earning between £ 55 a week and £ 90 a week the new rate for employers will be 7%; and for those earning between £ 90 and £ 130 a week the employer will pay 9%. The full employers' rate of 10.45% will apply only for those earning over £ 130 a week.

These changes represent substantial reductions in the cost of employing the lower paid. They will significantly improve the flexibility of the labour market and the prospects for jobs. I recognise that employers cannot be expected to welcome the increased cost of employing higher paid workers, but for business and industry as a whole the increase in the cost of the highly paid will be fully offset – indeed more than offset – by the reduced cost of employing lower paid workers.

Moreover, I propose to introduce a similar system of graduated National Insurance contribution rates for the employees themselves at the lower end of the earnings scale. At present those earning more than the lower earnings limit pay a flat rate of 9% on total earnings up to the upper earnings limit, and nothing on any amount they may earn above that limit.

This system makes National Insurance contributions a particularly heavy burden for the low paid.

I propose that, in future, those earning between £ 35.50 and £ 55 a week pay at the rate of 5%, and those earning between £ 55 and £ 90 a week 7%. Only those who earn above £ 90 a week will be liable to the full 9% on their earnings.

But I do not propose to abolish the upper earnings limit for employers' contributions. It is an integral part of the contributory system on which their benefit entitlement is based. Moreover, if it were abolished, those on the higher rates of income tax would face unacceptably high combined marginal rates taking into account liability to both tax and National Insurance contributions.

The changes I have proposed represent a substantial reduction in the burden of National Insurance contributions on lower paid employees. In addition, as I have already indicated, I propose a corresponding reduction in the contributions paid by the self-employed. The flat rate Class 2 contributions will be reduced from £ 4.75 to £ 3.50 a week.

My Rt Hon Friend the Secretary of State for Social Services will include legislation to give effect to his restructuring of National Insurance contributions in the Social Security Bill now before Parliament and I expect the new rates to take effect from the beginning of October. I should make it clear that these changes are not intended to affect benefit rights, and new rules will be introduced to protect those rights. Nor will the changes effect arrangements, for the contracted-out rebate.

The overall cost of these changes will be £ 450m in a full year, made up of £ 80m less in employers' contributions, £ 270m less in employees' contributions, and £ 100m less in contributions from the self-employed, in 1985-86 the total cost will be £ 160m.

The effect on job prospects will, over time, be substantial. The radical restructuring I have announced will encourage employers to take on the young and unskilled, and give them, in turn, an incentive to seek work at wages that employers can afford. The cost of employing some 8½m people on earnings of less than £ 130 a week will be reduced by almost £ 900m in a full year. It will cost an employer £ 3 a week less to employ a young person or unskilled worker at just below £ 90 a week.

And the take-home pay of some 3½m people with earnings up to this level will be further increased, on top of the significant real increases in income tax thresholds I have already announced. A single youngster on just under £ 90 a week will pay about £ 1.80 a week less in National Insurance on top of the reduction in his income tax bill of £ 1.15 a week – an overall increase in take-home pay of almost £ 3 a week.

The reduction in the total burden on the low paid – income tax plus employers' and employees' National Insurance contributions combined – is even more dramatic. For someone on £ 80 a week it is cut by up to 30% and at £ 50 a week it is cut in half.

These are changes of a major order. They amount to a direct and powerful attack on disincentives to employment. They tackle the problem of unemployment where it is most acute. They complete my Budget for jobs.

In this Budget, Mr. Deputy Speaker, I have reaffirmed the Government's commitment to the defeat of inflation of sound money. I have made further radical proposals for taxation and National Insurance, and abolished outright a third tax. In collaboration with my Rt Hon Friends the Secretaries of State for Employment, Education and Social Service, I have proposed a coherent and wide-ranging set of measures to promote new jobs. I commend this Budget to the House.

The following report and note were written by
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SWAZILAND:

1985 Budget Speech

– Proposals include new incentive package

On 12 February 1985, the Minister for Finance, Mr. B. Sibusiso Dlamini, presented his budget proposals to Parliament. While reporting no significant change in the country's economic situation since last year, the Minister did include among his proposals incentives designed to stimulate investment in Swaziland and, to some extent, to compete with those incentives offered by Swaziland's neighbours.

In assessing the problems which face the Swaziland economy, the Minister highlighted the minimal economic growth in the economy combined with an increasing population which leads in turn to less revenue being available when at the same time more is needed.[1] The budget deficit has been considerably reduced although it was thought that revenue spending is not likely to increase to any great extent. The Minister stressed the need for financial controls to be strengthened and expressed some satisfaction at progress already achieved in this respect.

With such difficulties in mind, the Minister's main priorities in this year's budget were to improve the level of efficiency in the collection of tax and the control on expenditure and of course, to strengthen the Government's revenue base.[2]

The following are the principal changes to the tax system outlined in the Budget Speech.

INCENTIVES

The Minister outlined the Government's intention to make the "greatest possible contribution to the reconstruction and development"[3] of Swaziland. However, he emphasized that the Government's role should be primarily a supportive one and the "major impetus for sustainable growth must come from the private sector".[4] On this basis and having considered the sometimes extraordinarily generous investment incentives offered by neighbouring countries, the Minister for Finance proposed a new package of financial incentives to investment in Swaziland.

It is proposed that all new manufacturing firms, not previously represented in Swaziland, would be exempt from company taxation for the first 5 years of operation provided that the cumulative net profits minus the cumulative wage bill for local employees exceed 150% of the value of fixed assets. The Minister explained that in the calculation of the profits during the tax holiday, the local wage bill would be deductible twice. This provision has been added because a "ceiling based purely on fixed investment militates against labour-intensive firms"[5] which are the firms the Government wishes to encourage. The proposal is intended to protect existing firms which have already made valuable contributions to the economy from subsidized competition. As an additional safeguard, there is a limit on tax exempt profits with the aim of minimizing the loss of revenue from firms which do not need the incentive of extra tax concessions to come to Swaziland.

In a bid to assist new firms in existing industries and expanding firms, it is proposed to simplify the system of allowances for capital expenditure. Investment allowances will be abolished and initial allowances will be raised to 50% on both industrial buildings and plant and machinery.

A further incentive was proposed with the intention of encouraging the flow of funds into 2 specific development oriented institutions. The Minister announced that the limits for the exemption of interest income from Swaziland Development and Savings Bank and from the Swaziland Building Society would be raised to E 10,000 (from respectively E 1,000 and E 4,000). In addition, the Minister proposes that all public tenders be subject to a local preference of 10% for all services and any goods which have a local value added of at least 25% and for which final processing occurs in Swaziland.

INCOME TAX

A number of proposals for change were made to the system of company and individual income tax.

In the area of company taxation, the housing allowance is to be raised to E 20,000 from its previous E 5,000 with a promise of regular review. The training allowance available to businesses and currently limited to the manufacturing sector is to be extended to all sectors. This allows for a double deduction of all expenses incurred on an approved training scheme.

In the realm of individual income tax, the Minister proposed the introduction of provisional tax payments for self-employed persons eliminating the advantage to those persons of being able to postpone tax payments. Along similar lines, in an effort to improve collection procedures and in order "to economise on meagre manpower resources"[6], taxpayers below a certain level of income will be made exempt from filing a tax return and they will not be required to pay tax other than that which is deducted under the P.A.Y.E. system (Pay-As-You-Earn). The Minister for Finance hoped that this substantially would reduce the number of assessments and enable the Tax Department to concentrate on en-

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1. Budget Speech at paras. 3 and 4.
2. Id. at para. 9.
3. Id. at para. 20.
4. Id.
5. Id. at para. 27.
6. Id. at para. 16.

suring greater compliance with the income tax law.[7]

In addition to these measures, and recognizing the "long-standing cry" of married persons, proposals for separate taxation of married couples will be laid before Parliament bearing in mind, however, the danger of an increase in the administrative burden.

In the field of income tax, the Minister pointed out his intention to examine other possibilities for raising revenue and improving the collection of taxes. Such proposals include the taxation of management or administration fees paid to non-residents and of a tightening of the taxation of non-resident entertainers and of fringe benefits. A review would also be made of the graded tax to result in low income earners paying less tax than those in the middle or higher income groups. It was also suggested to introduce a system of tax clearance certificate whereby taxpayers would not, for example, be issued with trading licences until their tax liability had been discharged.

INDIRECT TAXES

With the emphasis not only on control of expenditure, in an effort to widen the Government's revenue base, a sales tax was introduced in 1983 and implemented in 1984. According to the Minister, the sales tax is already proving to be a significant source of revenue "without undue disruption of existing trading patterns or any significant adverse affect upon the consumer's disposable income".[8] The hope is that by means of the sales tax, the Government will decrease its dependency on the South African Customs Union receipts and particularly, on "external factors of the kind which influence customs revenue"[9] and over which the Government has little or no control.

However the Minister admits that sales tax is not enough. On further examination, the Minister felt that the level of many fees, fines and licences have not kept pace with inflation and, in some cases, hardly even recoup administrative costs. He intends, therefore, to revise these miscellaneous taxes and licences with a view to their updating.

CONCLUSION

Swaziland does appear to have made some progress in redressing its budget deficit problems. However, as with many developing countries, the international recession and the strength of the U.S. dollar make an economic development in Swaziland still more difficult to achieve. It is to be hoped that the new measures aimed at strengthening financial control will result in less over-spending and that the efficiency with which tax is collected can be increased.

Of particular importance are the new provisions to encourage further investment, especially in sectors not already represented in Swaziland. Rumours which had suggested that the Government might (partly as an incentive measure) reduce company taxation or abolish it altogether appear to have been unfounded.

Throughout the Speech, the Minister has taken a very firm line and intends that these measures contribute towards the re-establishment of a sound financial policy and to the continued reconstruction programme; goals which the Minister intended "to spare no effort"[10] in order to achieve.

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[7] Id.
[8] Budget Speech at para. 10.
[9] Id.
[10] Id. at para. 72.

ZAMBIA:

1985 Budget Speech

On 25 January 1985, the Minister of Finance, the Honourable L. Mwananshiku, M.P., delivered his Budget Speech in the National Assembly.

The economic problems facing Zambia continued to be emphasized after yet another difficult year in which the increasing strength of the U.S. dollar has plagued many third world countries in their efforts to reduce budget deficits, grapple with debts and make progress in their long-term development programmes.

The Zambian economy was further weakened by decline in several areas. Output in the manufacturing industry is down and production in the mining sector is still on the decline. Agriculture has been affected particularly by adverse weather conditions and shortages of imported inputs. A similarly sad picture is reflected in other sectors of the economy with constructions, transport and communications, electricity etc. all on the decline by an average of 6.5%. In addition, the Government's heavy reliance on revenue from excise, sales and mineral export taxes has been highlighted and all these are to be increased in an attempt to find further resources. Zambia is already facing some difficulties in servicing its debts and concern has been expressed at its tendency to fall behind in current payments. However, in the light of these problems, the Minister insisted that market forces would be allowed to operate and that price controls would not be reintroduced.

The following are the principal changes to the tax system outlined in the Budget Speech. The majority of the changes are in the area of indirect taxation.

Companies and businesses

No alteration was proposed to the rates of company tax. A further incentive is offered to employers who employ a handicapped person. Under the job credit scheme, the credit allowed in such circumstances will be increased from K 300 to K 1,000 per handicapped person employed each year. Additionally, with effect from 1

April 1985, 50% of the Selective Employment Tax payable by certain employers will be allowed for income tax purposes although it is not entirely clear to which category of employers this applies. Selective Employment Tax is payable by employers on the basis of the total emoluments payable to employees.

Those involved in the export of minerals will be subject to a higher rate of Mineral Export Tax. All minerals exported will now be liable to tax at a rate of 10% (previously 8%). This tax is not deductible for income tax purposes.

Individuals

In the realm of individual taxation, personal allowances are to be increased to K 2,100 for the married allowance and K 900 for the single person's allowance.

Withholding taxes

A new withholding tax is to be introduced applicable to management fees paid for services rendered by resident companies and individuals. The rate of withholding will be 30%. Further changes to withholding taxes announced are an increase from 25% to 45% of the tax which is deductible from payments to contractors and transporters and the withholding tax deductible from rents is to be reduced from 35% to 15%.

Indirect taxes and fees

The rates of sales tax are to be increased. In future, both imported goods and local products and services will be charged to tax at 15%. In the area of customs duties, legislation will be introduced to abolish manufacturers' rebates. In addition, all goods not subject to customs duty at present will be made liable for duty with the exception of agricultural imports. Excise duties are all increased with effect from 26 January 1985.[1]

A number of fees and levies are also to be increased. Motor vehicle licence fees will be raised but there are no details yet as to the amount of the increase. A new manufacturing licence fee is to be introduced payable at a flat rate of K 250 for every manufacturing licence issued. New fees will be introduced in respect of specified land transactions. For example, an application to transfer or sell property (or its renewal) will be subject to a fee of K 100. An application to mortgage property would be subject to a fee of K 50. In addition, the airport passengers' fees will be increased with effect from 26 January 1985 to K 5 for domestic and K 20 for international flights.

Export incentives

With a view to the need to earn more foreign exchange, the Minister proposed a number of measures to encourage and to facilitate exports.

Documentation for exportation is to be simplified; in particular, documents will only be issued by the Ministry of Commerce and Industry, cutting out the need to obtain any additional documents from other Ministries or from the Bank of Zambia. The Export Promotion Council will be converted into the Export Promotion Board with overall responsibility for expanding the export drive. An export revolving fund is to be established and, in addition, companies will be permitted to retain 50% of their foreign exchange export earnings to purchase raw materials etc., for a period of up to 60 days instead of the previous 21 days.

Conclusion

While the Minister has warned of yet another hard year ahead for Zambia, it would appear that there are grounds for some optimism particularly because of the continued improvement in the agricultural sector. The dependence of the Government for revenue from customs and excise duties and other indirect taxes results in a large part of the Budget changes being concentrated in these areas. The exemptions accorded to the agricultural sector highlight the emphasis placed by the Government yet again on this area. This forms a "crucial part of the government's plan to shift the basis of the economy from mining to agriculture, with industry in a supportive role"[2]. However, with such a great reliance on one resource (i.e. copper) as a source of earnings, the Minister will continue to find his hands tied and the prospects for expansion and diversification correspondingly narrowed.

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[1] Increases of excise duties are as follows:
   (a) Petroleum products up by between 1 ngwee to 4 ngwee per litre
   (b) clear beer up by 8 ngwee per bottle
   (c) opaque beer up by 17 ngwee per litre
   (d) cigarettes up by between 1 ngwee to 3 ngwee

[2] "Zambia: Revenue shortfall threatens budget plans", African Economic Digest, 1 February 1985, p.11.

NEW ZEALAND:

1984-85 Budget Speech

By Patricia Dunn

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In his 1984-85 Budget speech on 8 November 1984, the Minister of Finance, the Honorable R.O. Douglas placed strong emphasis on a commitment to firm monetary control, to reducing the fiscal deficit and to maintaining a realistic exchange rate.[1] In an effort to reduce the deficit, during the summer the dollar had been devalued, controls on interest rates were removed and it was announced that the Export Performance Taxation Incentive would be phased out by 1987.

Public sector and social equity

In order to provide a sound basis for recovery,[2] this Budget will reinforce policy changes already adopted and will take those policies further. In the public sector, measures are to be taken to ensure that State enterprises contribute to the financing of Government expenditure. At the same time, it will be necessary to protect low-income families from the harsh effects of the new policies. This will be accomplished through a low-income assistance package.

Public sector measures include, inter alia:
- agricultural and forestry subsidies to be reduced or removed;
- the price of State supplied electricity and coal to be increased progressively to the full cost of supply; a first increment on 1 April 1985 at a 25% increase in bulk electricity and a 35% increase in coal for non-export sales;
- road user charges to increase by an average 46%;
- domestic airways dues for air transport to increase by 75% (1/2 the full rate for helicopters);
- the Post Office to pay $93 million to the Government in lieu of taxes plus a $62 million dividend on substantial capital invested in its activities.

Social welfare measures include, inter alia:
- a non-taxable payment of $10.00 per child to be provided in addition to the Family Benefit;
- an increase in the Principal Earner Rebate from $312 to $520 per annum;
- an increase in social security benefits and war pensions;
- child supplement to increase by $2.00 per week.

The above social welfare measures will be financed partly through an increase in the standard rate of personal income tax (from 31.5% to 33%)[3] and partly through removal of the subsidy on milk.

In addition to these measures, the Government will impose a surcharge of 25¢ to the dollar on superannuation plans, other than the National Superannuation Plan, over $5,200 per year; institute interim measures (pending a comprehensive review) to increase the availability of housing; increase the Medical Benefit for children by up to $10,00 per medical visit and add some 260 teachers to the educational system as well as increase educational grants.

Interim tax measures

The Minister of Finance pointed out that the present tax system is seriously flawed. It places too much weight on the direct taxation of personal incomes while permitting many forms of income and expenditure to go untaxed. High marginal rates combined with a less than comprehensive tax base provide incentives to invest in unproductive areas of the economy and encourage tax avoidance and evasion, according to the Minister. These effects, in turn, reduce growth rate and job creation.

The Government plans to initiate a reform of the tax system that promotes long-term objectives.[4] In the interim, this Budget adopts several measures in conformity with these objectives. These include increasing taxes on alcoholic beverages, tobacco products and motor vehicle fees as well as the following major modifications:

Fringe benefits tax

A 45% fringe benefits tax (payable quarterly) on employer-provided cars and low-interest loans will be implemented from 1 April 1985. Discounted, subsidized or free goods will also be taxed where administratively possible. All employers irrespective of income tax status will be liable for this tax, including government departments and agencies. The estimated revenue yield is $150 million in a full year.

Personal tax exemptions removed

As a first step in removing distortions in the taxation of life insurance and superannuation and related areas and pending review in this area, the personal tax exemption for life insurance premiums and superannu-

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[1] 1984 Budget Speech by the Honorable R.O. Douglas, the Minister of Finance, delivered to the House of Representatives on 8 Novembere 1984. Printed by the Government printer, Wellington, New Zealand, p.2.

[2] Total net Government spending for 1984/85 is forecast to be $15,556 million, an increase of 9.2% over 1983/84; total receipts estimated to be $12,795 million, an increase of 14.8% over 1983/84. The deficit before borrowing for 1984/85 is forecast to be $2,761 million. p. 23, 1984 Budget.

[3] The new standard rate will apply to a slightly extended bracket, $6,000 to $25,000 per annum – instead of to $24,000. p. 13, 1984 Budget.

[4] These long-term objectives are stated as: to introduce a greater degree of equity into the tax and benefit systems; to minimize the distortionary impact of the taxation system on resource allocation by reducing anomalies and concessions, widening the tax base and lowering marginal tax rates; to make the tax system more certain and simple. p. 18, 1984 Budget.

ation contributions[5] will be abolished in respect of:
- life insurance;
- personal lump-sum annuation; and
- non-subsidized employee lump-sum superannuation.

Rates and home mortgage interest rebates discontinued

The income tax rebate for interest payments on first home mortgages is discontinued[6] as of tonight. The income tax rebate for rates and Chatham Island dues will terminate with effect from the next income tax year, i.e. 1 April 1985. These changes are expected to increase revenue in 1985/86 by about $27 million.

Sales tax reductions[7]

Certain rates of wholesale sales tax, notably on computer equipment, records, recorded tapes, blank magnetic tapes and cosmetics will be modified, reducing revenue by an estimated $14 million in 1984/85 and $41 million annually thereafter.

Tax reform

In emphasizing the necessity for tax reform, the Minister of Finance stated that future tax reform is to be concentrated primarily in reducing and flattening the rate of personal income tax[8] and placing a greater reliance on indirect taxation, to be achieved by introducing a Goods and Services Tax (GST).

Goods and services tax (GST)[9]

The new GST, to be implemented on 1 April 1986 and to replace the current wholesale sales tax, is a value-added tax system. The GST will apply, at a simple rate, to all transactions up to and including the retail level.

The GST will be the most far-reaching tax reform since the introduction of PAYE in 1957, according to the Minister of Finance. The tax, to be administered by the Inland Revenue Department, will be a major undertaking for both the Government and the trading community. The Government intends to release a White Paper[10] outlining its policy regarding the GST and to solicit public submissions on facilitating introduction of the tax. Final design will be decided after consultation with trade associations, interested parties and the public.

The Government foresees raising an additional $1,000 million in revenue in 1986/87 from the GST. It is anticipated that the tax should be applied at the rate of approximately 4% to achieve this goal.

The tax, applicable to all domestic and imported goods and services (but not to exports), will include basic necessities such as food. Noting the potential hardship this could place on low-income families, the Minister stressed that alternative methods of income maintenance for low-income households, applied through the income tax and social welfare systems, should be considered rather than excluding food from the GST.[11]

Business tax

No changes were made in business taxation which will undergo a major review next year with a view toward reaching conclusions on reform options in conformance with the Government's long-term objectives.

Conclusion

The 1984 Budget addresses medium-term goals – on the basis that it is neither feasible nor desirable to attempt to bring accounts immediately into balance. The aim is, rather, to commence the process of reshaping the Government's operations to ensure that all Government expenditures are fully justified and, therefore, to minimize the tax burden. The economic situation facing this Government was the most precarious experienced in the memory of most New Zealanders.[12] The measures taken in this Budget, along with tax reforms over the upcoming 18 months, combined with modification of the personal income tax and the introduction of GST should augur well in bringing about the desired improvements in the economy of New Zealand.

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[5] Exemptions abolished on contracts entered into after midnight, 8 November 1984, but not for existing contracts. p. 19, 1984 Budget.

[6] Rebate discontinued for houses purchased after 8 November 1984. The plan will continue for those already eligible. p. 20, 1984 Budget.

[7] Measures effective as of midnight 8 November 1984. p. 20, 1984 Budget.

[8] Although New Zealand taxes are not especially high (New Zealand ranks 15th amongst the 23 OECD countries), it is unusual in the high proportion of direct taxes (income, wealth and capital) as compared to indirect taxes. *Goods and Services Tax* at 7-8.

[9] Discussed in the 1984 Budget at 22. Also in a separate booklet, *Goods and Services Tax*, complementing and explaining the tax announced in the 1984 Budget.

[10] Release of the White paper anticipated for early 1985.

[11] Excluding food from the GST would reduce the taxable base to 80% of its potential which would mean that the tax on all other goods and services would have to be at least 25% higher for the tax to yield the same revenue. *Goods and Services* at 21.

[12] The economic situation referred to consists of, inter alia, a massive rise in unemployment, a devaluation of the currency, a protracted period of price freezes and controls and a fiscal deficit amounting to 9% of GNP. 1984 Budget, passim.

IFA news

FRENCH BRANCH

The Board of Directors of the French Branch met on 26 February 1985. The following decisions were taken:

(1) On 20 June 1985 a meeting will be held for the members of the French Branch who plan to attend the London Congress of IFA in September 1985. The meeting will start on 17:30 hours and will be held in the offices of A.N.S.A. (15, place du Général Catroux, Paris). The purpose of this meeting is to specify and coordinate the material which the members will present when the two main subjects are being discussed.

(2) On 26 June 1985 a meeting will be held starting at 17:00 hours in the main room of the C.N.P.F. (salle Chaillot), 31, avenue Pierre 1er de Serbie. This meeting will study the two subjects of the 1986 New York Congress of IFA, i.e.:

- *Taxation of assets transferred into and out of the taxing jurisdiction.* The General Reporter is Mr. Y. Kergall (France) and the National Reporter from France is Mr. Chambault.
- *Currency fluctuations and international double taxation.* The General Reporters are Mrs. M. Burge and Mr. P. Farber (U.S.A.). The National Reporter for France is Mr. Gourmelen.

(3) On 3 December 1985 the Fall session will take place which will be preceded by a meeting of the General assembly of the French Branch. The meeting will be held at the Royal Monceau (35, avenue Hoche, Paris) and will be followed by a dinner to which representatives of the French tax authorities, the Cour de Cassation (Supreme Civil Court) and the Conseil d'Etat (Supreme Administrative Court) will be invited. Subject to discussion will be the tax problems connected with the takeover of businesses in difficulties. The President and the Secretary General of the French Branch will take the necessary steps to organize the discussions and they may invite a Belgian or Canadian tax expert to participate.

(4) The French Branch envisions organizing a conference outside Paris. Of similar conferences held during the past years the one which was held in Lyon was the most successful thanks to the active support of the members of the University of Lyon, the participation of its students, the choice of subject and the organization of the meeting. Therefore, contact will be established with the universities of Nice or of Montpellier in order to organize a similar conference in one of those cities in 1985. A conference held in Montpellier could perhaps be a joint French-Spanish conference and a conference held in Nice could perhaps be a joint French-Italian conference.

The meeting of the Permanent Scientific Committee

Mr. Baconnier reported on the meeting of the PSC of 15-16 February 1985. Some highlights are:

Future Congresses of IFA:

- 1985 United Kingdom (London)
- 1986 United States (New York)
- 1987 Belgium (Brussels)
- 1988 Netherlands (Amsterdam)
- 1989 Brazil (Rio de Janeiro)
- 1990 Sweden (Stockholm)
- 1991 Spain
- 1992 Japan
- 1993 Switzerland

London Congress:

In addition to discussion of the main subjects, the following seminars will be held:

- The regime of non-profit entities,
- The interpretation of some special points in tax treaties,
- The tax aspects of new financial techniques,
- The U.K. tax system.

Professor Fontaneau will be a panellist for the first subject.

New York Congress:

Apart from the discussion of the main subjects, seminars will be held on the following subjects:

- Legislation against the use of tax havens,
- Tax treatment of trusts,
- Local taxes and the unitary tax system,
- Tax regime of real property capital gains derived by non-residents.

Brussels Congress:

The main subjects to be discussed during the Brussels Congress will be:

- The concept of residence of companies,
- The liquidation of companies.

Publications

The President indicated that the French journal *Journal de droit des affaires internationales* recently published a very good article entitled "La France et les conventions internationales" (France and international treaties) by Mr. Jean-François Court. The same journal will publish an article by Mr. Pinson entitled "La fiscalité des groupes" (The taxation of groups) which will be based on the discussion of the meeting of the French Branch in November 1984.

CANADA:

Declaration of Taxpayer Rights

On 28 February 1985 Revenue Minister Beatty published Canada's first Declaration of Taxpayer Rights which may be also the world's first declaration on this subject. Although in most countries the rights of the taxpayer are laid down in the Constitution and ordinary laws, an official solemn summary of the basic principles of conduct of the tax administration against the taxpayer is unusual. The contents of the Declaration are of utmost interest; for this reason the Declaration is reproduced below in its entirety.

Revenue Canada Taxation
Revenu Canada Impôt

Declaration of Taxpayer Rights

The constitution and laws of Canada entitle you to many rights that protect you in matters of income tax. You are entitled to know your rights. You are entitled to insist on them. You are entitled to be heard, and to be dealt with fairly.

Helping you exercise your rights remains an important role of the staff of National Revenue Taxation at its district offices and other locations. Fair treatment of a complaint is one of your greatest rights.

FAIR TREATMENT IN ALL DEALINGS WITH NATIONAL REVENUE TAXATION MEANS IMPORTANT RIGHTS TO:

Information
You are entitled to expect that the Government will make every reasonable effort to provide you with access to full, accurate and timely information about the Income Tax Act, and your rights under it.

Impartiality
You are entitled to an impartial determination of law and facts by departmental staff who seek to collect only the correct amount of tax, no more and no less.

Courtesy and Consideration
You are entitled to courtesy and considerate treatment from National Revenue Taxation at all times, including when it requests information or arranges interviews and audits.

Presumption of Honesty
You are entitled to be presumed honest unless there is evidence to the contrary.

FAIR TREATMENT UNDER THE CONSTITUTION AND LAWS OF CANADA INCLUDES IMPORTANT RIGHTS TO:

Privacy and Confidentiality
In addition to other constitutional and legal rights, you have a special right that personal and financial information you provide to National Revenue Taxation will be used only for purposes allowed by law.

Independent Review
You are entitled to object to an assessment or reassessment if you think the law has been applied incorrectly. To protect this right, you must file your objection within 90 days of the assessment or reassessment. Filing an objection will start an independent review by departmental appeals officers. If they don't resolve the matter to your satisfaction, they will explain how you can appeal in the courts.

An Impartial Hearing Before Payment
Until you have had an impartial review by the Department or a court, you may withhold amounts disputed in formal objections filed after January 1, 1985. If you appeal to a higher court, you will be able to provide equivalent security instead of paying those disputed amounts.

Certain exceptions, set out in legislation to guarantee these rights, are applicable to frivolous appeals to the courts, or where collection is clearly in jeopardy.

YOU ARE ENTITLED TO EVERY BENEFIT ALLOWED BY THE LAW

You have a right to arrange your affairs in order to pay the minimum tax required by law. You can also expect your government to administer tax law consistently, and to apply it firmly to those who try to avoid paying their lawful share.

Canada

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with income from foreign sources

FOREIGN CORPORATIONS
with income earned or taxable in the U.S.

NONRESIDENT ALIENS
receiving income from, or taxable in the U.S.

If you fit any of these categories – or if you counsel, advise, or in any way service any of these categories – U.S. TAXATION OF INTERNATIONAL OPERATIONS will be an invaluable new tool for you.

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In clear, direct language, backed up by practical, tested practices of acknowledged experts in international business operations, this work spells out how the taxpayer can best take full advantage of every popular, every sophisticated, and every little-known tax-saving device.

Authoritative, specific guidance from one source devoted exclusively to this kind of vital help has been non-existent – until now.
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Personal response to this new publication has been even more enthusiastic than our most optimistic projections. Subscriptions are now being accepted by mail for $ 309 a year.

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Paris, OECD, 1985. 73 pp.
(B. 105.921)

INTERNATIONAL

TRANSFER PRICING AND
Multinational Enterprises.
Three Taxation Issues.
Reports of the OECD Committee on Fiscal Affairs.
Paris, OECD, 1984. 91 pp.
This report by the Committee on Fiscal Affairs is a supplement to the Report on Transfer Pricing and Multinational Enterprises of 1979.
The 3 issues supplementing the 1979 Report consider, successively, the ways in which a multinational enterprise may be relieved from "economic double taxation" when transfer prices are adjusted by tax authorities; transfer pricing in the particular sector of banking; and issues related to the allocation of management and service costs for tax purposes.
(B. 105.864)

WADE, John Alexander.
The role of the value added tax in international trade.
Ann Arbor, University Microfilms Int. [300 N. Zeeb Road, Ann Arbor, MI 48106], 1982. 151 pp.
A thesis submitted to the Faculty of Purdue University in partial fulfillment of the requirements for the degree of Doctor of Philosophy.
(B. 105.890)

STUTZER, Michael Jay
On tax effort revenue sharing.
Ann Arbor, University Microfilms International [address see above] 1981. 136 pp.
A thesis submitted to the Faculty of the Graduate School of the University of Minnesota in partial fulfillment of the requirements for the degree of Doctor of Philosophy.
(B. 105.901)

WORLD ECONOMIC SURVEY 1984,
current Trends and Policies in the World Economy.
New York, United Nations, 1984. 109 pp.
(B. 105.853)

THE TAX/BENEFIT POSITION OF
Production Workers 1979-1983.
Paris, OECD, 1984. 233 pp.
Study on the tax/benefit position of the average production worker examining the individual income taxes and employees' social security contributions in the OECD-member countries during the years 1979, 1981 and 1983. It is intended to update the results regularly.
(B. 105.839)

INTERNATIONAL

International

INTERNATIONAL CO-OPERATION
in tax matters. Guidelines for international co-operation against the evasion and avoidance of taxes (with special reference to taxes on income, profits, capital and capital gains).
New York, United Nations, 1984. 44 pp.
(B. 105.910)

THE INTERFISC TAX TREATY
Service.
Compiled and edited by Brian Kieran, John R. Dewhurst and Eurolex (A European Law Centre Service).
London, Professional Publishing Ltd., 1984.
Loose-leaf publication designed to provide information on a number of chosen important countries concerning double taxation treaty status and dividend, interest and royalty withholding taxes and related subjects. 75 countries are dealt with.
(B. 105.919)

INTERNATIONAL CO-OPERATION
in tax matters.
Report of the Ad Hoc Group of experts on international co-operation in tax matters on the work of its second meeting.
New York, United Nations, 1984. 12 pp.
(B. 105.911)

REPORT ON THE FOURTH
technical conference at New Delhi, India, 7-13 December 1983 convened by the Commonwealth Association of Tax Administrators (CATA).
The subject: Use of resources including – staff deployment and management of tax offices – staff retention, staff pay and incentives – selection of cases for audit – handling large volume of returns.
Proceedings of the conference and list of participants are appended.
London, Commonwealth Association of Tax Administrators [Marlborough House, Pall Mall, London SW1Y 5 HX], 1984. 150 pp.
(B. 105.917)

LATIN AMERICA

Barbados

TAX & INVESTMENT PROFILE.
Barbados.
New York, Touche Ross International, 1984. 20 pp.
(B. 18.335)

Mexico

GARCIA-ALBA, Pascual.
The introduction of the value added tax in Mexico. A study on tax evasion.
Ann Arbor, University Microfilm Int. [300 N. Zeeb Road, Ann Arbor, MI 48106], 1982. 230 pp.
A dissertation presented to the Faculty of the Graduate School of Yale University in candidacy for the degree of Doctor of Philosophy.
(B. 18.336)

Panama

TAXATION IN PANAMA.
International Tax and Business Service.
New York, Deloitte Haskins & Sells, 1984. 59 pp.
(B. 18.334)

MIDDLE EAST

Oman

TAX & INVESTMENT PROFILE.
Oman.
New York, Touche Ross International, 1984. 40 pp.
Information on investment, exchange controls, establishing a business in Oman and its taxation. Special rules for petroleum companies and taxes on individuals and other municipal taxes, Zakat and other fees are also dealt with.
(B. 56.554)

NORTH AMERICA

Canada

GUIDE FISCAL DES ENTREPRISES ET
Personnes Etrangères – Canada.
Nouvelle édition.
Collaboration: Stikeman, Elliot.
Dossiers Internationaux Francis Lefebvre.
Paris, Editions Francis Lefebvre, 1984. 190 pp., 149 Bfrs.
The Canadian tax system (federal, provincial and municipal) relevant to business organizations and individuals with emphasis on French investors or those doing business with Canada. The France-Canada tax treaty is also dealt with.
(B. 105.882)

RIDDELL, Thorne.
Doing business in Canada.
Amsterdam, Klynveld Kraayenhof & Co., 1984. 94 pp.
Guide providing information on investment and taxation in Canada. Governmental incentives and social security regulations are also dealt with.
(B. 105.907)

JUMP, G.V.; Bossons, J.
Studies on Taxation and Fiscal Policy.
Toronto, Institute for Policy Analysis, University of Toronto, 1981. 40 pp.
The studies published are: Financing the Federal Deficit, The Effect of Indexing Capital Cost Allowances and Economic Effects of the Capital Gains Tax.
(B. 105.881)

United States

DREISSIG, Hildegard.
Unternehmenserwerb und Besteuerung in den U.S.A.
2. Auflage.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1984. 346 pp., 46 DM.
Second revised edition of monograph on acquisition of a company and taxation in the U.S.A. The establishment of a subsidiary and a permanent establishment as well as the computation of profit is set out.
(B. 105.906)

PRENTICE-HALL.
1985 Federal Tax Handbook.
Englewood Cliffs, Prentice Hall Inc., 1985. 744 pp.
Handbook designed to give immediate information on all new federal income tax laws, regulations, court decisions, rulings both to business organizations and individuals as well as for filing company and personal income tax returns for the 1984 tax year.
(B. 105.880)

INTERNAL REVENUE CUMULATIVE
Bulletin 1984-1. January-June.
Washington, Government Printing Office, 1984. 794 pp.
Compilation of all official rulings, decisions, executive orders, tax treaties and other items of a permanent nature, published in the weekly bulletin in the first half of 1984.
(B. 105.916)

MADIGAN, Richard E.
Taxation of the Shipping Industry.
Second Edition.
Centreville, Cornell Maritime Press [P.O. Box 456, Centreville, MD 21617], 1982. 108 pp., 20 $.
Monograph on the regulation of the shipping industry, tax and accounting as well as the US taxation of foreign shipping companies.
(B. 105.883)

EXECUTIVE'S GUIDE TO TRAVEL and entertainment expenses.
London, Arthur Andersen & Co., 1985. 32 pp.
(B. 105.991)

TAX CREDITS CLAIMED BY Hawaii residents.
State of Hawaii, Department of Taxation, 1983. 52 pp.
(B. 105.993)

LARKINS, Ernest R.
The impact of taxes on U.S. citizens working abroad.
Research for Business Decisions, No. 66. Ann Arbor, UMI Research Press, 1983. 129 pp., $44.
Distributor: Bowker Publishing Co., Erasmus House, Epping, Essex, CM16 4BU, United Kingdom.
Study examining whether changes in the taxation of foreign-earned income have any effect on the presence of American employees in foreign countries.
(B. 105.948)

Loose-Leaf Services

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Australia

AUSTRALIAN INCOME TAX – LAW AND PRACTICE

- Current taxation
  releases 47, 48
- Cases
  releases 44-46

Butterworths, Pty., Ltd., Chatswood.

Austria

STEUERLICHE TABELLENSAMMLUNG

release 56
Wirtschaftsverlag Dr. Anton Orac, Vienna.

Belgium

DOORLOPENDE DOCUMENTATIE INZAKE B.T.W./LE DOSSIER PERMANENT DE LA T.V.A.

releases 163, 164
Editions Service, Brussels.

FISCALE DOCUMENTATIE VANDEWINCKELE

Tome XII, release 42
CED-Samsom, Brussels.

FUNDAMENTELE BELGISCHE WETGEVING

release 20
Kluwer, Deurne.

GUIDE FISCAL PERMANENT

releases 462, 463
Editions Service, Brussels.

GUIDE PRATIQUE DE FISCALITE

Tome II, release 50
CED-Samsom, Brussels.

Canada

CANADA INCOME TAX GUIDE REPORTS

release 221
CCH Canadian Ltd., Don Mills.

CANADA TAX SERVICE – RELEASE

releases 525, 526
Richard de Boo, Ltd., Toronto.

CANADA'S TAX TREATIES

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Butterworths Pty., Ltd., Scarborough.

CANADIAN CURRENT TAX

release 14
Butterworths, Pty., Ltd., Scarborough.

CANADIAN SALES TAX REPORTS

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CCH Canadian Ltd., Don Mills.

CANADIAN TAX REPORTS

releases 673-675
CCH Canadian Ltd., Don Mills.

DOMINION TAX CASES

releases 3, 4
CCH Canadian Ltd., Don Mills.

FOREIGN INVESTMENT IN CANADA

Report Bulletin
release B9
Prentice-Hall of Canada, Ltd., Scarborough.

Common Market (EEC)

HANDBOOK VOOR DE EUROPESE GEMEENSCHAPPEN

- Verdragsteksten en aanverwante stukken
  release 241

Kluwer, Deventer.

France

BULLETIN DE DOCUMENTATION PRATIQUE DES TAXES SUR LE CHIFFRE D'AFFAIRES ET DES CONTRIBUTIONS INDIRECTES

release 36
Editions Francis Lefebvre, Levallois-Perret.

DICTIONNAIRE PERMANENT – DROIT DES AFFAIRES

releases 157, 158
Editions Législatives et Administratives, Paris.

DICTIONNAIRE PERMANENT – FISCAL

releases 212, 213, 217
Editions Législatives et Administratives, Paris.

JURIS CLASSEUR – CODE FISCAL

release 217
Editions Techniques, Paris.

German Federal Republic

ABGABENORDNUNG – FINANZGERECHTSORDNUNG

Tipke, Kurse
relese 45
Verlag Dr. Otto Schmidt, Cologne.

DOPPELBESTEUERUNG

Korn – Dietz – Debatin
release 49
Verlag C.H. Beck, Munich.

KOMMENTAR ZUM ERBSCHAFTSTEUERGESETZ UND SCHENKUNGSTEUERGESETZ

R. Kapp
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Verlag Dr. Otto Schmidt, Cologne.

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KOMMENTAR ZUR EINKOMMENSTEUER

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Verlag Dr. Otto Schmidt, Cologne.

STEUERERLASSE IN KARTEIFORM

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STEUERRECHTSSPRECHUNG IN KARTEIFORM

release 397
Verlag Dr. Otto Schmidt, Cologne.

Luxembourg

ETUDES FISCALES

release 74
Imprimerie Saint-Paul, Luxembourg.

The Netherlands

DE BELASTINGGIDS

release 114
S. Gouda Quint – D. Brouwer, Arnhem.

BELASTINGWETGEVING

Editie J.M.M. Creemers
release 53
S. Gouda Quint – D. Brouwer, Arnhem.

BELASTINGWETGEVING:

- Inkomstenbelasting 1964
  release 126

Noorduijn, Arnhem.

CURSUS BELASTINGRECHT

release 103
S. Gouda Quint – D. Brouwer, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING:

- Gemeentelijke Belastingen e.a.
  release 82

Kluwer, Deventer.

FISCALE WETTEN

release 136
FED BV, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER:

- Belastingheffing bij invoer
  release 327
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  releases 171, 172

Kluwer, Deventer.

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Kluwer, Deventer.

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Samsom, Alphen a.d. Rijn.

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Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE:

- Inkomstenbelasting 1964
  releases 454-457
- Vennootschapsbelasting 1969
  release 128
- Investeringsregelingen
  release 64

Kluwer, Deventer.

Norway

SKATTE-NYTT

A. release 1
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Norsk Skattebetalerforening, Oslo.

South Africa

THE TAXPAYER'S PERMANENT VOLUME ON INCOME TAX IN SOUTH AFRICA

David Meyerowitz – Erwin Spiro
release 10
The Taxpayer Publ. Co., Capetown.

Spain

MANUAL DE LA ADMINISTRACION

Boletín de información
release January
T.A.L.E., Madrid.

MANUAL DE LA ADMINISTRACION

release January
T.A.L.E., Madrid.

United Kingdom

SIMON'S TAX CASES

releases 2-7
Butterworth & Co., London.

SIMON'S TAXES

releases 87, 88
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE

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Butterworth & Co., London.

U.S.A.

FEDERAL TAXES – REPORT BULLETIN

releases 8-10
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE

releases 18-21
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE REPORTS

releases 16-20
Commerce Clearing House, Inc., Chicago.

STATE TAX GUIDE

releases 839, 840
Commerce Clearing House, Inc., Chicago.

TAX IDEAS – REPORT BULLETIN

releases 2, 3
Prentice-Hall, Inc., Englewood Cliffs.

TAX TREATIES

release 396
Commerce Clearing House, Chicago.

U.S. TAXATION OF INTERNATIONAL OPERATIONS
releases 1-3
Prentice Hall, Inc., Englewood Cliffs.

Conference Diary

MAY 1985

City Business Conference Limited: Multi Currency Accounting (including: taxation aspects of currency transactions). London (United Kingdom), 21 May (English).

International Tax Planning Association (ITPA): 10th Annual conference (including: The Kingdom of the Netherlands: ten years later (an overview); the Netherlands partnership; new and prospective treaties with the Netherlands; customs duties and international transactions). Amsterdam (Netherlands), 22-24 May (English), 22-24 May (English).

Seminar Services: Holding and Finance Companies (including: tax treaties and tax planning). Amsterdam (Netherlands), 23-24 May (English).

Longman Seminars: Tax Effective European Compensation Planning (including: tax favoured compensation generally). Brussels (Belgium), 20 May, Geneva (Switzerland), 22 May, London (United Kingdom), 23 May (English).

JUNE 1985

Business Research International: Joint Ventures in the United States; legal, tax and financial aspects (including: tax aspects of U.S. joint ventures; tax aspects of U.S. joint ventures from the U.K. perspective). London (United Kingdom), 13 and 14 June (English).

European Study Conference Limited: The Channel Islands: An Offshore Financial Centre. The U.K. Tax Issues. St. Helier (Jersey), 14 June (English).

European Study Conference Limited: VAT in Europe. Amsterdam (Netherlands), 20 June (English).

European Study Conference Limited: International Conference on Trusts and Company Mobility for the Protection of Wealth (including: trusts and continental tax treaties). Luxembourg (Luxembourg), 25 and 26 June (English).

JULY 1985

Hartford Institute on Insurance Taxation: Second Annual International conference on Insurance Taxation. Montreux (Switzerland), 1-3 July (English).

World Peace Through Law Center: The Tax Panel discusses: Taxation, National cooperation encourages international trade. Berlin (West), 21-26 July (English, French, Spanish, German).

SEPTEMBER 1985

39th Annual Congress of I.F.A.: I. The assessment and collection of tax from non-residents. II. International double taxation of inheritances and gifts. London (United Kingdom), 8-13 September (English, French, German, Spanish).

Interphil: Interphil II (International Standing Conference on Philanthropy): Increasing government reliance on voluntary action – crisis or challenge? (including: comparative tax incentives for companies). Workshops on tax concessions and incentives to greater giving (a) by nation and (b) by international agreements. Venice (Italy), 26-28 September (English).

OCTOBER 1985

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: International tax law and tax planning (Seminar). St. Gallen (Switzerland) 21-24 October (German).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Business Research International, 57/61 Mortimer Street, London W1N 7TD, United Kingdom.

City Business Conference Limited, 41 Ladbroke Grove, London W11 3 AR, United Kingdom.

European Study Conference Limited, Kirby House, 31 High Street East, Uppingham, Rutland LE 15 9 PY, United Kingdom.

Hartford Institute on Insurance Taxation, Avon Commons, 49 West Main Street, P.O. Box 845, Avon, Connecticut 06001 U.S.A.

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

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Interphil, Cedar House, Yalding, Kent, ME 18 6JD, United Kindom.

ITPA, 33a Warwick Square, London SW1V 2AD, United Kingdom.

Longman Seminars, Longman Group Limited, 21-27 Lamb's Conduit Street. London WC1N 3BR, United Kingdom.

Seminar Services S.A., Boulevard de Pérolles 7a CH-1700 Fribourg, Switzerland.

World Peace Through Law Center, 1000 Connecticut Avenue, NW, Washington DC 20036, U.S.A.

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European Study Conference Limited: The Channel Islands; An Offshore Financial Centre. The U.K. Tax Issues. St. Helier (Jersey), 14 June (English).

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Fiscal System and Economic Development: The ASEAN Case

By Mukul G. Asher

I. INTRODUCTION

In this paper a broad evaluation of the fiscal policies of the countries belonging to the Association of South East Asian Nations (ASEAN) is attempted. The paper first provides salient features of the revenue and expenditure systems of ASEAN countries; and then concentrates on the effects of these systems on economic growth, equity, and stabilization. The paper suggests that from the mid 1960s to 1980, the nature and structure of the fiscal systems at least did not hinder impressive macro-economic performance of the ASEAN countries. However, various internal and external factors have created difficult fiscal dilemmas for the ASEAN policymakers, making the task of fiscal policies much more difficult in the 1980s.

Fiscal policy as a conscious policy designed to influence economic variables is an offshoot of the Keynesian revolution. By now, there is almost universal acceptance of fiscal policy as one of the instruments for managing the economy. There have, however, been significant differences in the objectives towards which fiscal policy has been directed and the manner in which it has been analysed between the market-oriented industrial economies and the developing countries in general. In the former, fiscal policy has usually been directed towards the stabilization objective, with emphasis being placed on how it affects aggregate demand management.[1] In the developing countries, fiscal policy has been directed primarily towards economic growth and development and only secondarily towards stabilization aspects. The above differences are not too surprising as at least until recently, economic growth in the industrial market economies was taken for granted, while in the developing countries growth was to be promoted by conscious use of the government and the public sector.[2] However, as growth becomes somewhat less automatic in the former, and as some of the middle income developing countries such as those belonging to the Association of South East Asian Nations shift towards greater reliance on the private sector to bring about growth, a degree of convergence between the two may be likely in the future.

The role of government in ASEAN countries has been large and multi-dimensional. Three important aspects of this role consist of budgetary or fiscal policies; the policies towards state or public enterprises; and other areas such as government rules and regulations, attitudes towards industrial relations, foreign enterprises, and orientation (inward vs. outward) of the economy, government efforts at achieving legitimacy, and broad manpower policies. The three aspects are obviously interrelated. In broad terms, the role of government in ASEAN has been characterized by paternalism, pragmatism, and outward orientation [Asher, 1984a].

In the ASEAN countries, the traditional model of economic growth and development, with its emphasis on capital formation, and on the belief in what *Yotopoulos* and *Nugent* have called three interrelated ideas forming the red thread of neo-classical dogma, have dominated the thinking of the policymakers. The three ideas are that development is a gradual and continuous process; that this process is harmonious and cumulative; and that economic growth is beneficial and that spread and trickling down effects of economic growth are significant [Yotopoulos and Nugent, 1976, pp. 9-11]. It is from the above that the desire to pursue outward-orientation strategies has perhaps emanated in the ASEAN countries.

Contents

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[1] For an exposition of fiscal policy from this point of view, see *Blinder* and *Solow* [1974].

[2] The emphasis on growth and development would require greater emphasis on aggregate supply effects, on composition of output, and on more micro-economic effects of fiscal policy than is the case in the industrial market economies.

In this paper, a broad evaluation of the fiscal policies of ASEAN countries is attempted. These policies concern taxes and incentives, expenditure policies, and modes of financing government surplus or deficit.[3] It must be admitted that defining fiscal policy in this way does make the distinction between fiscal, monetary and debt policies even more ambiguous than is generally the case. Pure fiscal policy is usually defined to comprise all tax and expenditure transactions of government as they affect the size of the government's net debt inclusive of central bank money in private hands, while monetary policy determines its composition. However, as *Blinder* and *Solow* suggest, "nothing much besides academic division of labor depends on the choice of a precise demarkation between fiscal and monetary policy. In practice the two are interconnected; wherever we place the boundary we are bound to poach across it." [Blinder and Solow, 1974, p. 4]. It is hoped that the definition of fiscal policy adopted here, even though slightly ambiguous, will not hinder the analysis.

The above definition of fiscal policy would require inclusion of all levels of government in the analysis. However, because of data and other limitations, only the fiscal policies of the central governments are included. This omission is, however, unlikely to affect the broad qualitative conclusions as the fiscal systems of ASEAN countries are highly centralized.[4]

It may be useful to briefly enumerate major external and internal developments with which fiscal policy in ASEAN countries has had to cope in the last decade or so.

Among the major developments in the world economy over the past few years has been the persistence of slow growth in the OECD countries to which grouping almost all the major industrial market economies belong.[5] While the recent rapid growth of the U.S. economy has temporarily reduced somewhat the importance of this development, the relatively low growth rates of OECD countries have affected both investment and trade flows and prospects as these concern the ASEAN countries. The continuation of trade and especially budget deficits in the U.S. have also created an added uncertainty in the external environment facing ASEAN countries.

Another major external development has been the severity of the external debt crisis. This has been considerably exacerbated by the mercantilistic economic policies followed by the United States in recent years, and by the generally monetarist macroeconomic policies of such countries as West Germany and the United Kingdom. Moreover, there is unlikely to be any significant change in the policies of these countries in the near future. Two major manifestations of these policies have been: (i) persistently high real interest rates whose significance is now considerably greater due to the variable interest rates charged to the borrowers, and the increased importance attached to ideological, political, and security considerations of the United States, and (ii) to the narrow financial criteria to determine both the conditions and the levels of resource flows to the developing countries from international economic institutions such as the World Bank, the IMF, and even the regional development banks in which the United States and its allies have predominant leverage. Without going into the merits of the second manifestation,[6] it may be stated that it is likely to help the ASEAN countries given their close relationships with the U.S. and its allies, and because of the personal agreements concerning the direction and the pace of reform needed in individual ASEAN countries between the policymakers and the World Bank and IMF as noted below.

Another major external development has been the decline in the price of oil as compared to the price obtaining immediately after the second oil shock of 1979. According to World Bank [1984, p. 27] figures the price has fallen by US$6 per barrel since 1979. Moreover, the oil market has continued to be soft, and there has recently been renewed downward pressure on the price of oil. This development may be expected to adversely affect Indonesia, Malaysia, and Brunei which are important oil producers and which rely substantially on oil revenue to finance government expenditure. While the effect on Thailand and the Philippines may be expected to be favorable, it is difficult to determine a priori the effect on Singapore as it is both a larger importer as well as exporter of petroleum products. In analysing the impact of the fall in price of oil, the recent strength of the U.S. dollar should be taken into account as oil trade is conducted largely in that currency.

Internal factors include the desire to restructure economies, effects of political developments in countries such as the Philippines on economic variables, problems relating to the financial systems and structure discussed in the next section of this paper, and problems relating to the performance and management of public enterprises and off-budget agencies. Another important internal development has been the expressed desire of ASEAN countries, with the exception of Brunei, to enhance the role of the private sector in the economy.

The effects of the external and internal factors mentioned above have been particularly evident in various macroeconomic indicators such as the current account and overall deficit in the government budget, the size and composition of the external and internal debt, and

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[3] To the extent enterprises receive loans and grants from the budget, and contribute revenue to the government, they would be a part of the analysis of fiscal policy as defined here.

[4] Thus, in the Philippines and Thailand roughly 90% of all revenue is accounted for by the central government, the corresponding proportion being 80% for Indonesia and Malaysia. Singapore and Brunei are unitary states.

[5] Thus, the GDP growth rate in the industrial market economies, which includes all the OECD countries except Greece, Portugal and Turkey, was 2.8% per annum during the 1973-79 period. The rate fell to 1.3% in 1980 and 1981, to -0.5% in 1982, and to an estimated 2.3% in 1983 [World Bank, 1984, Table 2.1, p. 11]. While growth rates, led by the strong recovery in the U.S., are likely to recover in 1984 and 1985, the outlook beyond that is at best uncertain.

[6] For a critique of the recent policies of the United States towards the World Bank, see *Anthony Rowley* [September 27, 1984, pp. 65-67]. In a more recent article, *Rowley* is even more pessimistic that the World Bank and ADB can play effective roles in alleviating poverty, at least if the U.S. has its way [February 14, 1985, pp. 72-73].

the balance of trade and the balance of payments. Except for the government budget deficit (discussed elsewhere in this paper), an analysis of the behavior of the other indicators is beyond the scope of this paper. It should, however, be noted that in recent years the movements in these indicators, in spite of some improvements, continues to remain sufficient adverse in all ASEAN countries, with the exceptions of Brunei and Singapore, to require various policy adjustments, including adjustments in fiscal policy.

The rest of this section is organized as follows. Firstly, a broad overview of the salient features of the revenue and expenditure systems of ASEAN countries is provided. This is followed by the appraisal of fiscal policy in ASEAN. It concentrates on the effects of fiscal policies on economic growth, equity, and stabilization. However, no attempt is made to be comprehensive, even with respect to those areas which are covered. Major areas excluded are the incorporation of fiscal policy into development planning, and international aspects of fiscal policies. The appraisal is followed by some concluding observations.

II. REVENUE AND EXPENDITURE SYSTEMS OF ASEAN: AN OVERVIEW

As noted, only the data for the central government are available. Therefore, the overview does not include revenue and expenditure of the state and local governments.

1. Revenue systems

The main features of the ASEAN revenue systems may be summarized as follows (Tables 1 to 3).

(1) Total revenue and tax revenue to GDP ratios vary considerably among the ASEAN countries (Table 1). Thus, total revenue to GDP ratio varies from 92.5 for Brunei to 13.5 for the Philippines. The above ratio is also high (close to 30%) for Singapore and Malaysia. The Philippines is the only ASEAN country for which both the above ratios declined between 1975 and 1983. This is somewhat surprising as increased revenue effort has been one of the items of IMF conditionalities which the Philippines had agreed to undertake.[7]

(2) While both Malaysia and Singapore have similar total revenue to GDP ratios, tax to GDP ratio is much smaller for Singapore (Table 1). This is because of the much greater importance of non-tax revenue such as sale of lands, investment income, and user charges, in Singapore's revenue structure. While a major part of the difference may be explained by Singapore's special status as a city state, and by substantial ownership of land by the

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[7] Whether the IMF-World Bank strategy is the most appropriate one for the Philippines is a separate issue. While the Philippine government seems to agree with that strategy, others such as *Bello*, et. al. [1982], and *David* [1984], have expressed strong skepticism regarding that strategy. The obvious link between the development strategy adopted and the fiscal policy to be pursued should be noted not only in the case of the Philippines but also for other ASEAN countries.

TABLE 1
Central government revenue in ASEAN, aggregative ratios, selected years[a]

	Total revenue[b] / GDP			*Tax revenue / GDP*			*Non-tax revenue / Total revenue*		
Country	*1970*	*1975*	*1983*	*1970*	*1975*	*1983*	*1970*	*1975*	*1983*
Brunei	34.1	56.5	92.5[c]	18.6	38.8	38.5[c]	45.5	31.3	58.3[c]
Indonesia[d]	9.0 (7.2)	16.4 (7.2)	20.8 (7.1)	8.8 (7.1)	15.7 (6.6)	20.1 (6.4)	1.3 (1.6)	3.8 (8.5)	3.5 (10.2)
Malaysia[d]	20.0 (NA)	24.9 (22.9)	28.4 (24.3)	17.4 (NA)	22.3 (20.4)	25.1 (20.9)	13.0 (NA)	10.3 (11.1)	11.7 (13.7)
Philippines	11.4	15.7	13.5[e]	10.6	13.0	12.1[e]	6.9	17.1	10.0[e]
Singapore	20.1	20.3	29.0	13.1	15.4	20.4	35.0	24.6	29.6
Thailand	13.8	13.6	17.0[e]	12.5	12.0	15.4[e]	9.2	11.5	9.4[e]

Notes:

a. The data are for fiscal years for all countries except Thailand and the Philippines whose data are for calendar years. The fiscal year for Indonesia and Singapore is April-March. Brunei and Malaysia's fiscal year coincides with the calendar year. The Philippines' fiscal year till 1975 was July-June but since then it has coincided with the calendar year. Thailand's fiscal year is October-September. For Indonesia and Singapore, data refers to the period in which the fiscal year ends. Thus, data for 1970 refer to the period 1969-70.

b. Defined as tax + non-tax revenue. This may understate the total receipts of the Central government if the receipts of some of the government accounts are excluded. This is likely to be the case especially in Singapore, Malaysia, and Thailand.

c. Data refer to 1981.

d. Figures in brackets refer to data from which oil revenues are excluded.

e. Date refer to 1982.

Calculated from various sources noted below.

Sources: Brunei: Economic Planning Unit, *Brunei Statistical Yearbook*, various issues; Indonesia: Bank Indonesia, *Statistik Ekonomi – Keuangan Indonesia*, various issues; Bank Negara Malaysia, *Quarterly Economic Report*, various issues; Ministry of Finance, *Economic Report*, various issues, and *Estimates of Federal Revenue and Expenditure*, various issues; Philippines: Data supplied by the National Tax Research Center, Manila; and NEDA, *Philippine Statistical Yearbook*, various issues; Singapore: Republic of Singapore, Accountant-General, *Financial Statements*, various years; *Yearbook of Statistics*, various issues; Thailand: Bank of Thailand, *Monthly Bulletin* and *Quarterly Bulletin*, various years.

Singapore government, differing philosophies, objectives, and operating environment of public enterprises and of provision of public services may also have played a role in this difference.

In Brunei, because of the extraordinarily high investment income, the non-tax revenue component exceeds the tax revenue component (Table 1). The relatively small importance of non-tax revenue in Indonesia, Malaysia, the Philippines, and Thailand may indicate a need to pay greater attention to this source in mobilizing resources. This would require closer integration of decisions concerning expenditure and its financing.

(3) The predominance of oil revenue in the revenue system of Indonesia is also evident from the data in Table 1. Though oil revenue is not shown separately, this is also the case for Brunei. The importance of oil revenue, though still moderate, has grown considerably since 1975 in Malaysia. Thus, for these countries, an important medium term fiscal problem is devising of transitional revenue strategies for the post-oil era, or at least the era when the oil sector's fiscal importance is diminished as compared to the present. Indeed, as noted below, the bold and far reaching tax reform undertaken by Indonesia has the above as one of its major objectives.

Various implications of the above ratios for resource mobilization are discussed elsewhere in this paper.

(4) There is also wide divergence among the ASEAN countries concerning the reliance on major categories of taxes (Table 2), and on various tax items (Table 3). These may be summarized as follows:

(i) Taxes on income and profits are of overwhelming importance in Brunei and Indonesia due to the receipts from the oil sector. While in both Singapore and Malaysia roughly half of the total tax revenue is from this category, the composition differs. In Singapore, company income tax accounts for almost twice the share as compared to Malaysia (38.2 as compared to 20.6%). Thus, it is the oil company tax, reliance on which has increased from 8.7% in 1975 to 15.4% in 1983 (Table 3), which is largely responsible for the substantial revenue importance of taxes on income and profits in Malaysia.[8]

Personal income taxes are of relatively small importance in the revenue structures of ASEAN countries. The largest reliance on personal income tax is in Singapore (12.7% in 1982-83). Moreover, there has been a recent trend in ASEAN countries towards simplification and rationalization of the personal income tax structure.[9] The main objectives appear to be to provide incentives to the middle class professionals and to increase compliance. The compliance objective is quite significant in the personal income tax changes in Indonesia and the Philippines,[10] while the incentive objective appears significant in Singapore and Malaysia.[11]

(ii) For Thailand and the Philippines, taxes on goods and services represent the largest single category (Table 3). Thailand receives little more than half, while Singapore and Malaysia receive about a quarter of their tax revenue from this category. If oil revenues are excluded, both Indonesia and the Philippines receive slightly more than one-third of the tax revenue from this category.

The composition of this category also varies among countries. Singapore has no general sales tax. Its reliance on traditional excises, i.e. on petroleum, tobacco, and alcoholic products, declined substantially between 1970 and 1983. The decline, however, is not so drastic if motor vehicle taxes, i.e. road tax, ad valorem registration fees, and special tax on heavy duty oil engines, were included. The reliance then declines from 22.0% in 1970 to 14.7% in 1983. Thus, taxes on motor vehicles are of major importance in Singapore. Their importance in other ASEAN countries, especially Malaysia, may also be expected to grow.

In Malaysia, the importance of the sales tax has increased substantially due to the doubling of the rate from 5% to 10% in 1983. The scope of sales tax on services has also been expanded in recent years. This has meant a reversal of the revenue importance between sales and excise taxes in favor of the former.

The excise systems, with the exception of Malaysia, are limited to traditional items. The Malaysian excise system may be classified as intermediate as it includes certain consumer durables and intermediate inputs. The proposed VAT package of Indonesia expands traditional excises to cover many consumer durables. For the first time, VAT also levies excises on petroleum products. Its implementation, however, has been postponed from July 1984 to April 1985.

In general, recent tax changes in ASEAN countries may be expected to increase the revenue importance of this category.

(iii) In all ASEAN countries, the reliance on taxes on international trade and transactions has been declining. The reliance, however, is still significant in Malaysia, the Philippines, and Thailand. In Indonesia, only one-sixth of the total non-oil tax revenue is from this category. The revenue importance of export taxes is neg-

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[8] This proportion would almost double if petroleum royalties and cash payments, and export duty were added to the petroleum income tax. For details, see *Emerson* [1984].

[9] For details of various tax changes in ASEAN in recent years, see *Asher* [1984b].

[10] Though ironically, the Philippines has moved from global to schedular personal income tax to achieve this objective, while Indonesia has shifted in the opposite direction.

[11] Desire to bring its personal income tax rates more in line with that of Singapore to protect erosion of its revenue base may also have played a part in substantial personal income tax reductions announced in the 1985 Budget.

TABLE 2
Tax reliance (R) and effort (E) ratios, by major broad categories, central government of ASEAN selected years

		Taxes on income and profits		*Taxes on goods and services*		*Taxes on international trade*		*Other*[a]	
Country	*Year*[b]	*R*	*E*	*R*	*E*	*R*	*E*	*R*	*E*
Brunei	1970	90.4	16.8	0.8	—	8.7	1.6	0.1	0.2
	1975	98.2	38.1	0.1	—	1.7	0.6	0.4	0.1
	1981	98.6	38.0	0.1	—	1.3	0.5	0.0	0.0
Indonesia[c]	1970	38.0 (22.5)	3.4 (1.6)	34.9 (43.7)	3.1	27.1 (33.9)	2.4	NA (NA)	NA
	1975	71.2 (31.9)	11.2 (2.1)	13.5 (31.9)	2.1	13.7 (32.3)	2.1	1.6 (3.9)	0.3
	1983	82.7 (45.5)	16.6 (2.9)	11.4 (34.2)	2.3	5.0 (15.8)	1.0	0.9 (4.5)	2.0
Malaysia[c]	1970	32.9 (NA)	5.7 (NA)	23.7 (NA)	4.1	40.9 (NA)	7.1	2.5 (NA)	0.5
	1975	71.2 (31.9)	9.8 (7.8)	24.4 (26.8)	5.5	31.2 (34.2)	7.0	0.6 (0.6)	0.0
	1983	48.3 (38.9)	12.1 (8.3)	24.5 (29.0)	6.2	26.9 (31.8)	6.7	0.3 (0.3)	0.1
Philippines	1970	26.2	2.8	39.9	4.2	25.4	2.7	8.5	0.9
	1975	22.7	3.0	34.3	4.5	36.7	4.8	6.3	0.7
	1982	21.8	2.6	37.6	4.6	30.0	3.6	10.6	1.3
Singapore	1970	29.5	3.9	30.4	4.0	18.3	2.4	21.8	2.8
	1975	46.5	7.1	23.7	3.6	11.5	1.8	18.3	2.9
	1983	51.1	10.4	24.2	4.8	7.5	1.5	17.2	3.7
Thailand	1970	15.2	1.9	45.5	5.8	36.6	4.6	2.7	0.2
	1975	20.2	2.4	50.1	6.0	28.4	3.4	1.3	0.2
	1982	26.2	4.0	51.4	7.9	20.9	3.2	1.5	0.3

Notes: — = Nil or negligible.

a. Includes taxes on property, including duties, payroll taxes, and certain unallocated taxes.

b. See footnote a., Table 1.

c. Figures in brackets refer to the data from which oil revenues are excluded.

Sources: Calculated from the same sources as for Table 1.

TABLE 3
Central Government of ASEAN, a breakdown of major broad categories,[a] selected years

		Taxes on income and profits			*Taxes on goods and services*		*Taxes on international trade*	
Country	*Year*[b]	*Personal income tax*	*Company income tax*[c]	*Oil company tax*	*Excise taxes*	*Sales taxes*	*Import duties*	*Export duties*
Brunei	1970	—	90.4	NA	—	—	8.7	—
	1975	—	98.2	NA	—	—	1.7	—
	1981	—	98.6	NA	—	—	1.3	—
Indonesia[d]	1970	5.0 (6.3)	6.5 (8.1)	20.1	13.3 (16.7)	12.9 (16.1)	24.0 (30.0)	3.1 (3.9)
	1975	2.6 (6.1)	5.4 (12.8)	57.7	4.4 (10.4)	9.1 (21.5)	9.5 (22.5)	4.2 (9.8)
	1983	2.4 (7.6)	5.6 (17.7)	68.2	5.2 (16.3)	5.9 (18.6)	4.4 (13.7)	0.7 (2.2)
Malaysia	1970	8.4	NA	NA	11.9	—	27.9	13.0
	1975	9.6	25.5	8.7	9.8	5.9	17.5	13.7
	1983	11.2	20.6	15.4	7.2	8.1	15.6	11.3
Philippines	1970	NA	NA	—	13.3	19.0	16.9	9.1
	1975	NA	NA	—	13.2	14.7	26.9	9.8
	1982	NA	NA	—	14.2	18.1	29.4	0.5
Singapore	1970	NA	NA	—	14.2	—	18.3	—
	1975	12.5	33.9	—	8.8	—	11.5	—
	1983	12.7	38.2	—	4.6	—	7.5	—
Thailand	1970	7.6	5.3	—	17.9	21.7	31.7	5.0
	1975	7.8	10.4	—	21.2	22.9	24.3	4.1
	1982	11.4	12.2	—	26.9	21.4	19.2	1.7

Notes: — = Nil or negligible; NA: not available.

a. Details may not add up to the total due to the omission of certain items.

b. See footnote a., Table 1.

c. Oil company tax is excluded.

d. Figures in brackets refer to data with respect to non-oil tax revenue.

Sources: Calculated from the same sources as for Table 1.

ligible in all ASEAN countries except Malaysia.[12] The future revenue importance of import duties would depend on the policies concerning import-substitution and the development of an indigenous capital goods sector in ASEAN. Thus, import duties on motor vehicles in Malaysia have been restructured to make domestic production viable. Moreover, some of the measures taken to tackle budget and trade deficits concern increases in import duties and related taxes such as exit taxes.

(iv) The relatively small importance of personal income taxes coupled with the negligible importance of wealth taxes, and taxes on capital gains, indicates that there are few tax-related impediments to accumulation of wealth in countries. This is especially the case with respect to non-wage income.

2. Fiscal incentives[13]

The term "fiscal incentives" generally refers to tax related incentives to business firms, both domestic and foreign. Thus they constitute a part of tax-expenditure, i.e. special provisions in the tax laws designed to achieve various social, political, economic, and other objectives.

ASEAN countries have been providing various types of fiscal incentives since at least the mid-1950s. They have also entered into double taxation agreements with a large number of developed and developing countries. Various types of investment guarantees have also been provided by the ASEAN countries to foreign investors.

The direction in which incentives have been moving in recent years in various ASEAN countries may be briefly summarized as follows. In Singapore, the incentives have shifted toward high technology, high value-added activities, including computer related services, industrial design and engineering and technical services. Incentives in Malaysia are being re-examined in the light of the emphasis being put on developing the capital goods sector and the development of the motor-vehicle industry. Malaysia is also faced with a problem

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[12] The revenue importance of export duties for Thailand is somewhat understated as from 1976, rice premium has been separated from the revenue accruing to the government. However, even in 1975, export duties accounted for only 4.1% of total tax revenue (Table 3).

[13] Details of specific incentive laws may be found in *Ahmad Khan's* book cited under *Asher* [1984d].

TABLE 4
Aggregative expenditure ratios, central governments of ASEAN countries, fiscal years 1966 to 1983

	Total expenditure to GDP ratios										*Current expenditure to GDP ratio*					*Capital expenditure[d] to GDP ratio*				
Fiscal		*I*		*M*		*P*		*S*		*T*	*I*	*M*	*P*	*S*	*T*	*I*	*M*	*P*	*S*	*T*
year[a]	*A[b]*	*B[c]*	*A*	*B*	*A*	*B*	*A*	*B*	*A*	*B*	*A*	*A*	*A*	*A*	*A*	*A*	*A*	*A*	*A*	*A*
1966	NA	NA	24.7	NA	9.9	NA	20.5	NA	16.3	NA	NA	17.6	8.3	14.1	10.8	NA	7.1	1.5	6.4	5.4
1967	NA	NA	25.0	NA	10.2	NA	18.5	NA	17.0	NA	NA	18.5	8.5	13.5	12.6	NA	6.5	1.7	5.0	4.4
1968	NA	NA	24.0	NA	11.2	NA	19.5	NA	17.3	NA	NA	17.8	9.1	13.5	12.1	NA	6.1	2.1	5.9	5.1
1969	11.7	NA	23.1	NA	10.8	NA	21.0	NA	18.7	NA	7.6	17.5	8.8	15.7	12.8	4.1	5.6	1.9	5.3	5.9
1970	13.4	NA	25.2	NA	9.7	NA	23.4	NA	19.7	NA	8.4	25.2	8.3	16.9	13.3	5.0	6.3	1.5	6.5	5.9
1971	14.0	NA	29.6	NA	10.4	15.1	24.4	NA	18.2	NA	9.0	20.4	8.2	17.0	13.2	5.0	9.2	2.3	7.4	4.9
1972	14.4	14.9	33.9	33.9	12.4	16.1	23.1	19.7	16.2	16.6	8.6	24.1	9.0	14.9	12.3	5.8	9.8	3.4	8.2	3.8
1973	15.0	15.3	27.5	27.6	15.3	13.8	25.2	21.2	13.7	14.5	9.2	20.6	8.7	14.4	11.3	5.8	6.9	6.6	10.8	2.5
1974	17.8	17.9	31.4	30.5	19.3	17.1	22.7	19.8	15.6	20.1	9.1	21.9	12.5	13.7	12.1	8.6	9.5	6.9	9.0	3.5
1975	21.0	21.3	32.6	32.0	—	—	26.4	23.7	17.6	17.4	10.2	22.7	—	14.9	12.9	10.7	10.0	—	11.5	4.7
1976	22.5	22.3	30.4	30.1	14.1	15.6	28.1	23.1	17.4	17.2	9.9	21.6	12.1	16.6	13.0	12.5	8.8	2.0	11.4	4.5
1977	21.6	20.2	34.2	32.8	13.3	14.8	28.0	23.4	17.2	18.0	10.7	23.8	9.5	16.2	13.0	10.8	10.4	3.8	11.8	4.2
1978	21.1	20.5	32.7	30.9	13.1	14.7	28.9	22.5	16.7	18.2	10.9	22.2	10.0	16.8	13.1	10.2	10.5	3.2	12.1	3.6
1979	22.9	22.1	33.2	27.5	11.5	13.5	27.3	22.3	18.5	19.2	11.5	23.3	9.1	16.0	14.5	11.4	9.9	2.4	11.3	4.1
1980	24.8	24.3	42.1	34.4	12.2	14.2	31.4	24.2	17.5	18.5	12.3	27.2	8.6	16.3	13.8	12.5	14.9	3.7	15.0	3.5
1981	25.1	26.9	49.8	44.9	15.8	15.7	29.9	28.9	18.7	20.0	12.6	28.9	8.1	15.3	15.0	12.5	20.9	7.1	14.6	3.7
1982	24.1	NA	47.8	NA	15.5	NA	32.6	NA	15.8	NA	11.7	28.3	9.1	16.9	12.4[e]	12.3	19.5	6.4	15.6	3.3[e]
1983	NA	NA	41.8	NA	13.9	NA	NA	NA	17.0[e]	NA	NA	26.3	9.5	NA	13.6[e]	NA	15.5	4.4	NA	3.4[e]

Notes: NA: not available.

a. Fiscal years for various countries are as follows: I = Indonesia, the fiscal year is April, March; M = Malaysia, fiscal year coincides with calendar year; P = Philippines, fiscal year was July-June till 1975 but has coincided with calendar year since then; S = Singapore, fiscal year coincided with the calendar year till 1968, and April-March since then; T = Thailand, the fiscal year is October-September. Fiscal year 1966 refers to the data for 1966-67 for these countries whose fiscal year does not coincide with calendar year.

b. Data based on national sources.

c. Data based on IMF, *Government Finance Statistics Yearbook*, 1983.

d. Includes net lending..

e. Calendar year data.

Sources: IMF, *Government Finance Statistics Yearbook*, 1983. National Sources: Bank Indonesia, *Report for the Financial Year*, various issues; Bank Negara Malaysia, *Quarterly Economic Bulletin*, various issues; NEDA, *Statistical Yearbook of the Philippines*, 1975, NEDA, *Philippines Statistical Yearbook*, 1983; United Nations, *Statistical Yearbook*, 1981; Republic of Singapore, *Financial Statements*, various years; Bank of Thailand, *Quarterly Economic Bulletin*, various issues; ADB, Key Indicators, April 1984.

of how to retain those firms whose incentives are coming to an end and of reconciliation of incentives for free trade zones and development of heavy industry and encouragement of local entrepreneurs. In the Philippines, it is agriculture and resource-based industries which are receiving high priority. It has also moved to a value-added system of incentives. As part of its tax reform, Indonesia has abolished all incentives, though incentives already granted will remain in force until their expiry.

3. Government expenditure

Problems encountered in the comparative analysis of government expenditure are much more numerous as compared to the problems in comparative tax studies. Some of the problems include the differing degree to which a particular function is performed through a government budget, differing expenditure classification systems, differing coverage of the expenditure included in the data sources, and the manner of recording government expenditure. The ambitious attempt by the IMF to provide comparative fiscal data has not met with the desired success.[14]

4. Aggregative ratios

Table 4 presents the time series data concerning three aggregative ratios for the central governments of ASEAN countries. The corresponding income elasticity estimates are provided in Table 5. On the basis of these two tables, the following observations may be made.

One of the major difficulties in analysing government expenditure in ASEAN countries, even on the most aggregative basis, is evident from the data in Table 4. This concerns the considerable variation in the total expenditure to GDP ratio between the national sources and the data in the IMF's yearbook.[15] This is particularly the case for Malaysia and Singapore.[16] In many cases, even the direction of total expenditure to GDP ratio indicated by the two sources is different.[17]

Data in Table 4 suggest that Malaysia has by far the highest total expenditure to GDP ratio among the ASEAN countries, followed by Singapore, Indonesia, Thailand and the Philippines. The only country to exhibit a decline in total expenditure to GDP ratio as compared to the mid-1970s is the Philippines. Thus, excessively large budgetary expenditure, at least compared to its ASEAN partners, does not appear to be among the reasons for its present difficulties.

It is also noteworthy that the aggregative ratios have not increased smoothly during this period. There have been some sharp changes in the ratios followed by a period in which no particular trend is apparent. Thus, in Indonesia, both the total expenditure and capital expenditure to GDP ratios increased sharply between 1973 and 1975, followed by no particular trend until the second oil shock in 1979. Thus, the oil revenue dependent nature of the government expenditure is quite evident for Indonesia. The recent softening in the price of oil may also be expected to result in reduced government expenditure in Indonesia.

Malaysia's total expenditure to GDP ratio increased quite sharply during two periods, between 1970 and

TABLE 5

Income elasticity^a of central government expenditure in ASEAN

		Total expenditure		*Current expenditure*		*Capital expenditure*	
Country	*Time period*	*Income elasticity*	R^2	*Income elasticity*	R^2	*Income elasticity*	R^2
Indonesia	1969-70 to 1982-83	1.2394	0.9969	1.1432	0.9989	1.3639	0.9890
Malaysia	1966 to 1982	1.3062	0.9849	1.2139	0.9916	1.5006	0.9647
Philippines	1966 to 1980	1.1319	0.9684	1.0683	0.9800	1.3476	0.8660
Singapore	1966 to 1982-83	1.2092	0.9963	1.0496	0.9926	1.4800	0.9901
Thailand	1966-67 to 1981-82	1.0363	0.9870	1.1007	0.9918	0.8514	0.9216

Notes: a. Estimated through the following equations:

$\log G = a + b \log GDP$

$\log C = a + b \log GDP$

$\log K = a + b \log GDP$

where G = Government expenditure

C = current expenditure

K = capital expenditure

GDP = gross domestic product

all income elasticity coefficients are significant at 5% level.

Source: Same as for Table 4.

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[14] Some of the major limitations of the IMF data concerning government expenditure are listed in *Asher* and *Chia* [1984c].

[15] Though not shown, the same also applies to the other two ratios in Table 4.

[16] The divergence in the case of Singapore would have been even greater had certain adjustments not been made to the data from the national sources.

[17] Given this, one may expect even greater difficulties in analysing government expenditure in ASEAN at a more disaggregative level. Thus, a strong case exists for devoting greater efforts towards improving and perhaps harmonising expenditure data in the various ASEAN countries. Only then more meaningful analytical and detailed comparative studies may become possible.

1972, and between 1979 and 1981. However, since then there has been a substantial decline in this ratio. The first period coincided with the beginning of the New Economic Policy (NEP), and the second with an attempt to maintain the growth momentum in the face of the second oil shock in 1979. Since the policy resulted in a substantial increase in debt, especially external debt, the continuation of the 1979-81 expenditure policy was made difficult,[18] resulting in a substantial decline in the ratio since then.

In the Philippines, according to national sources, the total government expenditure to GDP ratio nearly doubled between 1970 and 1974, the period which includes the early years of martial law imposed in 1972. There was, however, a sharp fall in the ratio between 1974-75 and calendar year 1976. It is, however, interesting to note that the sharp increase in the ratio in the early 1970s is not indicated by the IMF data. Indeed, according to the IMF data, national sources substantially overstate this ratio for the period immediately following martial law, i.e. 1973 and 1974. However, since then, national sources have understated this ratio. Both sources, however, indicate that changes in this ratio have not been smooth. Recent economic difficulties are once again likely to reduce the government expenditure to GDP ratio further. Thus, Sacerdoti [11 August 1983] states, "following both the government's and the International Monetary Fund's programmes for strict austerity, but ignoring much of its own development priorities, the Philippines has tabled a no-growth budget for 1984 which drastically cuts into new capital outlays and equity investments in favor of routine expenditure." [p. 49]. The 1985 Budget, according to Galang is expected to reduce government expenditure in real terms by about 30% over the previous year [9 August 1984, p. 62].

In the case of Singapore, sharp increases in the total expenditure to GDP ratio occurred between 1979 and 1980, and 1981 and 1982. In the case of Thailand, capital expenditure to GDP ratio shows much greater variability. This also appears to be the case for Indonesia and the Philippines. This may reflect inability to control current expenditure. This trend is also evident in the proposed 1985-86 budget for Indonesia which envisages an increase in nominal expenditure of 12.1% over the previous year. The proposed increase in the development budget is, however, only 1.8%, while routine expenditure is to increase by 22.7%.

Another feature of the data in Table 4 is the high capital expenditure to GDP ratio exhibited by Malaysia, Singapore and Indonesia. In contrast, the ratio is quite low for Thailand and the Philippines, thus suggesting that off-budget agencies and the private sector play somewhat greater roles in the aggregate investment in these countries. Not only is the capital expenditure to GDP ratio low for these countries, but it has declined since the mid-1970s for the Philippines and since the early 1970s for Thailand. Again in contrast, for the other three countries, the end period ratio is 2 to 3 times the beginning period ratio. In Malaysia and Thailand, however, achieving greater efficiency and accountability of the off-budget agencies has become a priority concern.

It should, however, be stressed that growth and especially development implications of the government budget cannot be derived solely by examining the capital expenditure to GDP ratio. Not only is the distinction between the current and capital expenditure somewhat arbitrary, but many current expenditures such as on health and education and their efficiency may be far more important for growth and development than some of the items included in the capital budget.[19]

Table 5 provides income elasticity estimates for total, current, and capital expenditure of central governments of ASEAN countries. These estimates should be regarded as summary descriptive statistics. For forecasting purposes more sophisticated econometric techniques would be required. Except for Thailand, capital expenditure to GDP ratio is substantially above 1 for all ASEAN countries. In contrast, Thailand's income elasticity for capital expenditure is substantially below 1. Malaysia exhibits the highest income elasticity for all three categories. While its income elasticity of capital expenditure is similar to that of Singapore, its elasticity of current expenditure is much greater.

5. Functional and economic classification

Functional and economic classification of central government expenditure of ASEAN countries for the year 1981 is presented in Tables 6 and 7. The functional classification is of limited usefulness because it excludes net lending. As an example, much of public housing expenditure in Singapore is carried out through net lending to a statutory board from the budget. Thus, its exclusion would distort the proportions.

Nevertheless, some features do emerge. Expenditure share on education is significantly high in all the ASEAN countries, with the possible exception of Indonesia. This reflects the importance attached to manpower training and development in the ASEAN countries.

The share of defense expenditure is also high in the ASEAN countries. This is likely to continue and may even increase [ASEAN Forecast, Special Supplement, August 1984]. While the relationship between defense expenditure and development is complex, larger defense share in times of resource constraints would have important implications for development and for balance of payments.

Very high ratios observed for economic services correspond to the general observation that the ASEAN governments have emphasized economic growth. However, growing internal and external debt, combined with increased reliance on commercial borrowing and

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[18] The following figures concerning Malaysia may be instructive in this respect.

	1976-80	*1981-82*
Annual rate of growth of public debt	14.56	29.02
Annual rate of growth of GDP	17.48	4.10
Public debt as % of GDP	49.04	64.95
Domestic debt as % of total debt	78.56	71.35

Source: Salleh [1984, Tables 1, 3 and 4].

[19] For elaboration, see *Goode* [1984, Ch. 2].

high interest rates have increased expenditure on public debt, thus reducing the relative importance of economic services. Thus, debt service is expected to be almost a quarter of the total budget expenditure for 1985 in the Philippines [Galang, 9 August 1984, p. 63]. *Sricharatchanya,* in discussing the fiscal year 1985 budget for Thailand, remarks that the most striking feature of the new budget is a substantially larger allocation for debt servicing. In the face of constraints on revenue, this increase leaves limited resources for expenditure in other key areas." [5 July 1984, p. 53]. A similar situation prevails in Indonesia and Malaysia.

The ASEAN countries seem to have relied on the indirect and the trickle-down effects of growth to ensure adequate social security, welfare, and other community and social services. As a result, the share of these items in the government expenditure is low. The well publicised problems of the welfare state in the industrial countries also appear to have made the ASEAN countries more cautious in this regard.

Wide variation in the share of general public services is somewhat puzzling. It is unclear why the share of this category is so high in Indonesia and the Philippines and very low in Malaysia.

The following observations may be made concerning the economic classification of government expenditure in ASEAN. The capital expenditure component is quite high in ASEAN countries. Moreover, most of the net lending is to public enterprises.

Only in Indonesia and Malaysia are subsidies and other current transfers significant in relative terms. Both

TABLE 6
Functional classification of central government expenditure in ASEAN, 1981

Country	*Total expenditure*	*General public services*	*Defense*	*Education*	*Health*	*Social security and welfare*	*Housing and community amenities*	*Other community and social services*	*Economic services*	*Others, including public debt*
Indonesia	100.0	29.0	12.7	7.9	2.5	—	1.2	0.7	29.5	16.5
Malaysia	100.0	4.6	15.1	24.9	4.4	4.0	6.5	1.2	29.0	23.1
Philippines	100.0	23.7	14.2	14.2	5.0	1.2	4.6	0.8	55.3	4.3
Singapore	100.0	13.3	21.7	19.1	7.2	1.4	7.0	1.5	15.2	13.7
Thailand	100.0	8.3	20.6	19.3	4.3	2.6	3.0	0.4	23.3	18.3

Notes: — = nil or negligible.
Details may not add up to 100.0 due to rounding.
Source: Calculated from IMF, *Government Finance Statistics Yearbook*, Vol. VII, 1983, Country Tables.

TABLE 7
Economic classification of central government expenditure in ASEAN, 1981
(As percentage of total expenditure and net lending)

Country	*Total expenditure and net lending 1 = 2 + 5*	*Total expenditure 2 = 3 + 4*	*Current expenditure 3*	*Expenditure on goods and services 3.1*	*Wages and salaries 3.1.1*	*Other purchases of goods and services 3.1.2*
Indonesia	100.0	95.4	46.1	21.4	11.9	9.5
Malaysia	100.0	90.7	56.1	33.3	20.1	13.2
Philippines	100.0	81.2	54.7	41.0	22.9	15.6
Singapore	100.0	80.7	63.6	50.1	22.8	27.3
Thailand	100.0	97.3	74.3	58.9	28.8	30.0

Country	*Interest payments 3.2*	*Subsidies and other current transfers 3.3*	*Capital expenditure 4*	*Acquisition of fixed capital assets 4.1*	*transfers transfers 4.2*	*Total lending minus repayments 5*
Indonesia	3.1	21.6	49.3	34.2	3.7	4.6
Malaysia	8.3	14.4	36.3	4.5	31.5	9.3
Philippines	5.0	7.5	26.5	12.7	—	18.8
Singapore	9.6	3.9	17.1	15.3	0.5	19.3
Thailand	9.9	5.5	23.0	19.0	3.2	2.7

Notes: — = nil or negligible.
Details may not add up to 100.0 due to rounding and due to the omission of certain items.
Source: Calculated from IMF, *Government Finance Statistics Yearbook*, Vol. VII, 1983, Country Tables.

countries, however, have been attempting in recent years to reduce the proportion of this category even lower. As an example, fuel subsidies will be reduced by 53.6% in the proposed 1985-86 Indonesian budget.

The above suggests that both the effects and the causes of the growth of government expenditure are likely to be quite different in ASEAN countries when compared to the industrial countries. Not only is exhaustive government expenditure much higher in ASEAN, but much of it is being devoted to increasing productive capacity. As a result, it is the social productivity of the increased capacity and the efficiency with which this capacity is managed in the future, coupled with the creation of an appropriate environment for efficient operation of this capacity, which are likely to be among the crucial factors bearing on the desirability of the role of government expenditure in ASEAN.

III. FISCAL POLICIES AND ECONOMIC OBJECTIVES

The previous discussion has suggested that while the government and the public sector have played a dominant role in ASEAN countries, their fiscal systems are being adjusted with the objective of allowing the private sector to play a somewhat larger role than has been the case in the past. Moreover, government expenditures other than on public debt have decreased recently in several ASEAN countries. There have also been reductions in various subsidies and increases in administered prices and user charges.

This section attempts an appraisal of fiscal policies on economic growth, equity, and stabilization. Each is discussed in turn.

1. Fiscal policies and economic growth

The relationship between the fiscal system and economic growth and development is highly complex. It depends on such factors as whether a traditionalist or structuralist approach to development is adopted, paradigm used to analyse the relationship, and on policies other than fiscal policies followed simultaneously.

Given the above, only selected aspects of the relationship between fiscal policy and economic growth are examined here.

2. Resource mobilization

Performance concerning resource mobilization has an impact on economic growth in several ways. If the government is to play a dominant role, mobilization of financial resources is necessary. Also, given the present budgetary difficulties of several ASEAN countries, resource mobilization will be necessary for orderly growth and stability in the future.

The behavior of the total revenue, tax revenue, and non-tax revenue to GDP ratios was examined in the previous section [Table 1]. Moreover, as shown in Table 8, budget balance measures also generally deteriorated between 1974 and 1981. In spite of some improvement since then, the behavior budgetary indicators continue to be a source of concern to policymakers in several ASEAN countries.

What implications follow from the behavior of the above ratios concerning resource mobilization? To answer this, it may be useful to discuss the relationship between tax effort and potential and effective capacity to tax. The taxable capacity of a country is the presumed ability to generate taxes. Potential capacity may be regarded as a physical concept. It may be defined in at least two ways. The first would regard all income above a certain minimum level as potentially taxable. A more realistic definition would arrive at taxable capacity by defining the tax base of various taxes, such as the income tax, and the sales tax, as broadly as theoretically possible. In contrast, effective capacity has both economic, political, social, psychological, and other dimensions. Thus, political will, taxpayer discipline, perceptions regarding the fairness of the fiscal system and others should be included in defining effective capacity. Tax effort may be defined as the extent to which effective capacity is being utilized. However, given the above definition of effective capacity, increasing it would clearly represent an alternative to greater tax effort from the existing capacity. Many of the recent tax measures in ASEAN are designed to increase effective capacity to tax.[20] However, as will be noted below, to the extent that recent fiscal changes have worsened vertical equity, adverse effects on perceptions concerning the fairness of the fiscal systems are also likely to arise. The impact on taxable capacity of this development remains to be seen. This issue is of considerable relevance as increased compliance is considered to be the key to improved resource mobilization in ASEAN countries.

A major dilemma for the policymakers is, however, that the impact of measures to increase the effective capacity is likely to be felt in the medium term, while the present budgetary difficulties require measures which can mobilize resources in the short run. Indeed, this dilemma has implications for many other areas as well, as will be noted below.

Table 9 presents the 1979-81 average data concerning the modes of financing central government expenditure of ASEAN countries. The data demonstrate not only the differing needs of financing of individual countries, but also the manner of financing them. Thus, at least during the 1979-81 period, Indonesia and the Philippines relied on financing from abroad to a relatively much greater extent than was the case in the other ASEAN countries. As far as domestic financing is concerned, only Thailand relied on monetary authorities to a substantial degree, while non-bank financing was substantial only for Malaysia. The external debt problems of all ASEAN countries, except Singapore and Brunei, have forced them to rely less on external financing since the 1979-81 period.

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[20] Though many of the tax incentives, such as a more generous depreciation provision in countries such as Malaysia and Singapore are likely to lead to significant erosion of the tax base unless substantial increase in investment and economic growth takes place.

The classicial and Keynesian concepts of saving shown in Table 8 are not the only possibilities of direct resource mobilization by the government sector. The others are the forced saving through provident fund and other schemes. It would seem that only in Singapore and Malaysia is the potential of this avenue substantially utilized. Perhaps this is an area which may be usefully explored in mobilizing resources. One limitation however, is that while forced savings make greater resources available, they also increase cost of labor, unless all the burden is borne by the employee. Such increases in cost in turn would adversely affect demand for labor at least in the short run. Thus, there are limits to which labor surplus economies can pursue this strategy. Inequality in income would also limit the use of this strategy.

3. Structure of taxes and incentives to work, to save, and to invest

As shown in Table 3, personal income tax is not of overwhelming revenue importance. Moreover, except in Singapore, and to a somewhat lesser extent in Malaysia, the proportion of those working who are liable to income tax is not high. However, ASEAN countries seem to have accepted the proposition that marginal tax rates are important in determining incentives to effort and enterprise, and that it is the commitment and dynamism of middle and upper income groups liable to income tax that will to a large extent influence the extent to which the objective of eliciting greater participation from the private sector will be successful. As a result, marginal personal income tax rates have been substantially reduced in Indonesia, Singapore, Malaysia, and the Philippines. Thailand also appears to be considering such a move. It should, however, be stressed that at least in Indonesia and the Philippines the personal income tax base has been enlarged. So effective rates, except for the upper-income groups, may not have declined.

Two points, however, may be noted here. The first is the lack of empirical evidence concerning the magnitudes of the effects on effort and enterprise which may be expected. Secondly, when rates of personal income tax are reduced, at least in the short run there is likely to be a revenue loss. This has usually been made up by increasing sales and other taxes. Thus, if these increases have adverse incentive effects, they would need

TABLE 8
Measures of budget balance, central governments of ASEAN countries, 1974 and 1981

	Current A/C balance[a]		*Current A/C balance*		*Overall balance*		*Overall balance*	
	Capital exp. + Net lending		*GDP*		*Total exp. incl. net lending*		*GDP*	
Country	*1974*	*1981*	*1974*	*1981*	*1974*	*1981*	*1974*	*1988*
Indonesia	76.69	85.45	5.14	12.82	–8.36	–7.85	–1.56	–2.18
Malaysia	20.19	20.10	1.37	3.78	–20.89	–35.11	–5.50	–15.02
Philippines	61.66[b]	43.96	1.91[b]	3.13	–7.47	–25.38	–1.19[b]	–3.99
Singapore	118.58	101.03	10.02	11.50	7.78[b]	0.37	0.57	0.12
Thailand	38.18[b]	–18.65	1.29[b]	–1.00	–13.89[b]	–30.47	–2.10[b]	–6.36

Notes: a. Defined as total revenue, plus grants, minus current expenditure.
b. Data are for 1975.

Sources: IMF, *Government Finance Statistics Yearbook*, Vol. VII, 1983, Country Tables.
ADB, *Key Indicators*, Vol. XIV, April 1983.

TABLE 9
Modes of financing central government expenditure, ASEAN countries, 1979-81 average
(All figures expresses as percentage of total expenditure, including net lending)

Countries	Total revenue + grant 1=2+3	Grants 2	Total revenue 3=4+5+6	Tax revenue 4	Non-tax revenue 5	Capital revenue 6	Total financing 7=8+9	Financing abroad 8	Domestic financing 9=10+11 +12	Non-bank 10	Borrowing from deposit money banks 11	Monetary authorities 12
Indonesia	91.13	—	91.13	82.47	8.66	—	8.87	8.72	0.15	—	0.31	0.46
Malaysia	75.41	0.02	75.39	65.52	9.64	0.24	24.59	6.27	18.31	15.60	4.00	–1.29
Philippines	86.22	0.61	85.61	76.23	9.37	0.01	13.78	9.81	3.96	–0.32	5.25	–0.97
Singapore	104.08	—	104.08	67.98	28.65	7.45	–4.08	0.21	–4.29	–26.82	NA	NA
Thailand	74.84	1.90	72.94	65.91	7.03	0.01	25.16	5.41	19.75	2.36	7.19	10.03

Note: — = nil or negligible.

Source: Calculated from same source as for Table 8.

to be subtracted from the positive effects of reductions in personal income tax rates. The magnitude, the direction, and the timing effect would determine the extent to which recent tax changes have provided incentives for effort and enterprise.

The shift towards more regressive fiscal systems in ASEAN countries, as described in the previous section, is also expected by the policymakers to increase aggregate saving, thus implicitly assuming that marginal propensity to save increases with income.

As a part of the policies to promote business saving and investment, Singapore and Malaysia have progressively made depreciation rules more generous. In some cases these countries have allowed expensing of the cost of acquisition of certain assets. The empirical evidence on the effectiveness of these measures is, however, lacking. If, however, these measures also promote the corporate form of enterprise, and if this is considered more effective in raising growth, these indirect benefits may accrue.

ASEAN countries, with the possible exception of Singapore, have not always been happy with the results obtained from the incentive regimes utilized by them. Thus, in a recent study, *Ali* and *Hassan* put a part of the blame for Malaysia's technological dependence on the types of fiscal incentive regime prevalent in Malaysia [1984, p. 21]. Thailand is also reported to be concerned about the inadequate benefits in terms of employment, exports, and balance of payments from foreign investment [*Far Eastern Economic Review,* 2 August 1984, pp. 70-72]. Recent changes in the incentive system in the Philippines and the recent abolition of all fiscal incentives as a part of tax reform in Indonesia also implicitly suggest that the old incentive systems were not as effective as desired. As noted, Malaysia is also considering revising its incentive system.

Challenges facing the policymakers in designing fiscal incentives concern how to reduce their redundancy, how to reconcile fiscal incentives with the need to provide employment in an era of slow growth, how to induce greater technology transfers, how to design appropriate policies for those firms whose pioneer status is coming or has come to an end, and how to devise incentives to develop the local entrepreneurial and industrial base.

4. Policies to promote efficient resource use and allocation

The urgent need to pursue such policies arises from the adoption of a development strategy which emphasizes the increased role of the private sector, and outward orientation of the economy.

As a result, ASEAN countries have attempted to move to theoretically less distortive taxes, including reform of export duties; to rationalize and where possible eliminate consumption and production subsidies; to tighten up the operations of the off-budget agencies and to pursue privatization and deregulation moves.

However, the benefits of those policies are likely to be realized if at all only in the medium term. Various costs, including revenue costs of tax changes, are likely to be significant in the short run. This may explain why several ASEAN countries have had to take measures such as use of exit taxes, and surtax on imports, which conflict with the other measures mentioned above.

Inadequate conceptualization of the meaning of the term "dynamic efficiency", and neglect of how to bring such a concept into operation and integrate it with development strategy, makes the task of evaluating recent fiscal changes concerning their effects on efficiency in resource use and allocation more difficult.

5. Fiscal policies and equity

Traditionally, two aspects of equity are emphasized. These are the horizontal equity, i.e. how to treat individuals who are similar in taxpaying circumstances, and vertical equity, i.e. how to treat those who are in dissimilar tax paying circumstances. Regional, sectoral, and ethnic equity aspects are also relevant in ASEAN countries. The issue of regional equity is especially relevant for Indonesia because of a general feeling that Java has received disproportionate benefits from government's budgetary activities.

Recent changes in the fiscal systems in ASEAN are likely to improve the horizontal equity of the tax systems, especially if the administrative and other reforms lead to greater compliance with the system. If achieved, this would constitute a significant improvement in the equity of the fiscal system.

However, the changes in the fiscal system noted in the previous section, especially the shift to overall consumption taxes, increases in administered prices, and reductions in real government expenditure are likely to make the fiscal systems even less pro-poor than has been the case in the past. This is a source of concern because neither rapid growth nor non-fiscal policies are likely to redress the balance. This is particularly the case in the Philippines which has had to undertake IMF mandated measures. While those with a strong belief in the neoclassical dogma are not likely to be too worried about the equity issue, others are likely to be less sanguine. Thus, *Khor* argues for a rethinking of the development strategy of Malaysia in general and the role of government in particular [*Khor,* 1983, Ch. 5]. Similar arguments have also been made by *Bello,* et al. [1982] for the Philippines.[21] In Indonesia, the government has already indicated that greater equity may have to wait at least until the 1990s.

6. Fiscal policies and stabilization

As noted, stabilization has been considered the dominant objective of fiscal policy in the industrial market economies. However, in the open economies of

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[21] The alternative of radical shift in the development strategy is unlikely for several reasons. Growth in ASEAN owes significantly to the congruence of interests with the OECD countries, especially the U.S. and Japan. Therefore, any shift in the strategy which reduces this link would increase the cost of pursuing it significantly. Moreover, feasibility of alternative strategies suggested by *Khor* [1983] and *Bello,* et al. [1982], given the political, institutional, and other constraints, appears to many as at best uncertain.

ASEAN, the term stabilization acquires and has acquired a somewhat different content. Instead of being merely a short-term policy, it is to be evaluated in a medium-term context, and instead of merely emphasizing demand management aspects, cost-competitiveness and supply related aspects become more dominant. Moreover, traditional counter-cyclical fiscal policy, as for example suggested by *Young*, et al. for Malaysia [1980, p. 39], has run into external debt and other problems such as the uncomfortable balance of payments and foreign reserves position. This has coincided with the attempts to reduce the role of the government sector in the economy.

In some countries, e.g. the Philippines, restoring confidence has taken precedence over traditional stabilization objectives. In many of the ASEAN countries conflicts between objectives, especially between output and price stability objectives, have also become more acute. It would also seem that in societies where large disparities in purchasing power exist among income classes and regions, absolute level of cost of living rather than just changes in it, i.e. rate of inflation, should also be of some importance in defining stabilization objectives.

Several implications follow from the above. First, traditional counter-cyclical policies are no longer feasible or adequate even if that was the case in the past. A more sophisticated stabilization strategy is required. Second, the strategy needs to rely on more indirect methods and would need to be more micro-oriented than has been the case in the past. Third, supply management and orientation would also suggest a need to consider stabilization in a broader context than traditional fiscal and monetary policies. These would include incomes policies, exchange rate management, and general public sector management. Fourth, if the stabilization problem is to be regarded as a medium term problem and if benefits of many of the policies can only be attained in the medium term, then a need to devise policies to equitably share the burden of short run costs of these policies arises. As a result, equity aspects of stabilization policies assume greater importance, especially in the short run. Fifth, purely short-term demand management may not have the desired stabilization effects if the problem is medium term and if cost and supply considerations are important as argued above.

IV. CONCLUDING OBSERVATIONS

The generally impressive macro-economic performance of the ASEAN countries in the past two decades may be regarded as evidence that fiscal policies have at least not hindered economic performance. Indeed, given the crucial role of government in ASEAN countries, it may even be argued that sound fiscal policies have contributed to the satisfactory macroeconomic performance of ASEAN in the last decade and a half.

However, various internal and external factors have made the task of pursuing fiscal policies much more difficult in the 1980s. ASEAN countries are also at a critical juncture concerning the role of the government in the economy. Given their development strategies, they have little choice but not initiate many policies which would reduce the role of government in the economy. However, this is still an unchartered course for ASEAN. The uncertainties concerning the effects of these initiatives are heightened by the lack of empirical evidence of many crucial issues. Nevertheless, the future performance of the ASEAN economies would crucially depend on the extent to which various fiscal policy initiatives achieve their desired objectives. In particular, ASEAN countries are faced with four major fiscal policy dilemmas. Future contribution of fiscal policy in ASEAN is thus tied with the ability to successfully negotiate these dilemmas.

The four dilemmas are:
(1) reconciliation of objectives of promoting outward orientation of the economy and encouragement of exports with the urgent need to tackle significantly large deficits in the government budget and the balance of trade and payments;
(2) reconciliation of measures undertaken to increase efficiency in resource allocation and to provide incentives which would become effective in the medium term with the level and the dynamics of their short run costs;
(3) reconciliation of the need to enhance the legitimacy of the fiscal system with the need to pursue financial stability; and
(4) reconciliation of the paternalistic tendencies of governments in ASEAN countries with the objective of enhancing the role of the private sector.

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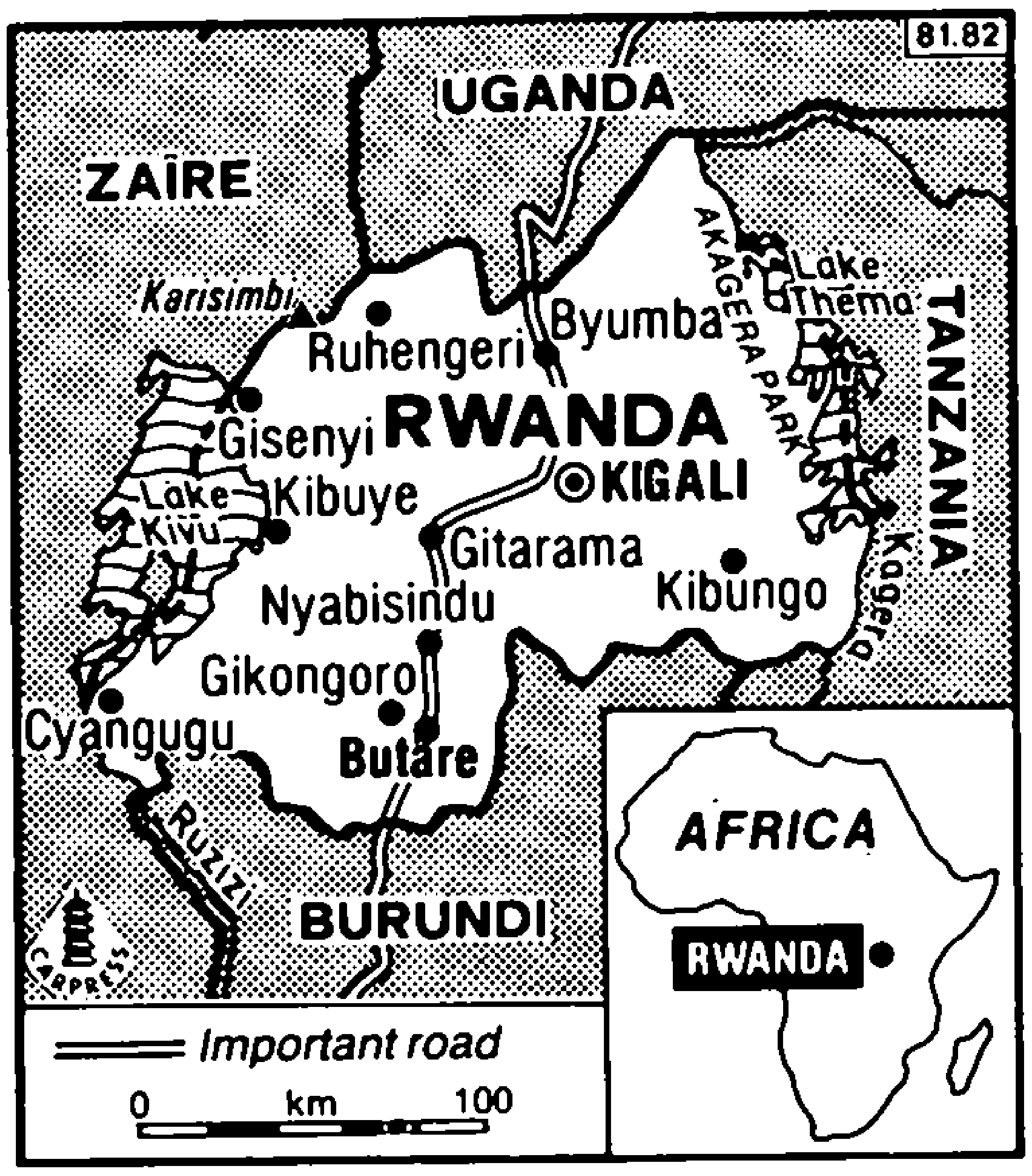
RWANDA:

Summary of Income Tax Assessment*

By Charles Kalinijabo

This article is taken from a larger study of Rwandan taxation: "Le rôle et la structure des impôts au Rwanda" (The role and structure of taxation in Rwanda), doctoral thesis presented by **Charles Kalinijabo**, 21 November 1983, at the University of Antwerp.



I. INTRODUCTION

For the past several years the International Bureau of Fiscal Documentation, at the request of the United Nations Economic Commission for Africa, has published a loose-leaf handbook (in English and French) entitled "AFRICAN TAX SYSTEMS"/"SYSTEMES FISCAUX AFRICAINS".

This publication covers practically all the African countries, with the exception of Rwanda. Therefore, we endeavour through this article to make the Rwandan tax system better known. To do so, we rely exclusively on income tax legislation, of particular interest to foreign investors, to whom we primarily address these remarks.

Contents

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* Translated and edited by Patricia Dunn, J.D., Managing editor of the *Bulletin for International Fiscal Documentation*.

General information:

- area: 26,338 square kilometres;
- population: 5.6 million (estimate 1983), (annual growth, approximately 3.7%);
- average annual income US$ 250 = 23,210 Rwanda Frs. (hereinafter Frs.), (mid 1981);
- economic structure: 91% of active population in agricultural sector, 2% in industry, 7% in service sector;
- production (mid 1981):
  - agriculture: 46% of GNP.
  - industry: 22% of GNP.
  - services: 32% of GNP.
- currency: Rwandan Franc indexed in relation to S.D.R. (Special Drawing Rights)
  - 1 SDR = 102.71 Frs.
  - 1 US$ = ± 101.35 Frs.
- literacy: 37%;
- salaried employees: 7.2% of active population;
- distance from seaports:
  - 1650 km (Dar-es-Salaam – Kigali)
  - 1700 km (Mombassa – Kigali).

Balance of trade:

	1980 in millions of Frs.	1981
Exports (FOB)	12,402	11,168
Imports (FOB)	– 18,179	– 18,005
	– 5,775	– 6,837

II. HISTORICAL, POLITICAL AND ECONOMIC DATA

A. Historical development

The history of Rwanda, like that of other African countries, has been modelled on and profoundly influenced by the colonial period and the decolonization that followed.

A sovereign and monarchical state until the end of the last century, Rwanda was unable to escape the greediness of the great European colonial powers. It was thus that it became, through the Conference of Berlin (1892) which ordained the partition of Africa, an integral part of German East Africa, regrouping Tanganyika (Tanzania less Zanzibar), Rwanda and Burundi. However, the German Empire, having lost the First World War (1914-1918) also lost, under the guise of sanctions, all of its colonies, which were partitioned among the allies. Rwanda, as well as Burundi, were put under the guardianship of Belgium which already possessed the neighbouring Congo (Zaire). Belgian guardianship continued without interruption until 1 July 1962, date on which Rwanda recovered its independence.

During the entire period of Belgian guardianship, the political and legislative organization of Rwanda, in its modern aspects, was closely linked with that of the Congo since the same Minister (the Minister of Colonies) and the same legislative organ (the Colonial Consul) presided over the destiny of the Congo and what was then called Rwanda-Urundi.

Since 1962, Rwanda has taken government into its own hands. During the period surrounding independence until 1973, its history and political life was largely dominated by the sometimes bloody quarrels of the two opposing principal ethnic groups. (Rwanda has three important but unequal ethnic groups, according to official reports: the Hutu, 85%; the Tutsi, 14% and the Twa, 1%).

The origin of these quarrels was a conflict for the exercise of power of which the Belgian administration was going to divest itself. In effect, during the colonial period, the Tutsi, an ethnic minority, under the impetus of the Belgian administration, was assured of a clear domination over the political, economic and social life of the country. It was this domination that the Hutu objected to on the eve of independence, fearing, justifiably, to be forever separated from any decisive power.

Thanks to the conjunction of several circumstances and to a bloody struggle, the Hutu found themselves holding the reins of power which they had struggled for and which they, thereafter had to jealously protect, often at the price of a considerable number of victims. But, to the growth crisis of the young republic there succeeded, happily, after 1973, a period of calm during the course of which the Second Republic and the current political economy were created and ratified.

B. Political organization

Politically, the Rwandan people developed in the framework of a unique political organization, the National Revolutionary Movement for Development (MRND) of which each citizen is a member.

Democracy, which in some other countries is linked to the multi-party system, is carried out here within the bosom of the aforementioned Movement, "a political framework outside of which no political opinion may be expressed".

From this same organization came the respective organs of power: President of the Republic, Chief of State, Chief of MRND and Chief of Government, as well as Members of the National Development Council (CND), a type of parliament, all elected by direct universal suffrage.

The political organization as describerd above was conceived in order to ward off the "ethnic demon" which threatened the stability of the country and, especially, to bring development efforts to a halt.

C. The economy and economic policy

The search for political stability was also accompanied by a constant effort to promote an economic take-off. The economy of Rwanda, it is true, still remains in a relatively embryonic state and growth indicators remain very weak. Additionally, the government plans and directs economic activity. This planning remains suggestive, however, and liberty is left to individuals in the allocation of their means. Only public sector enterprises are required to conform to the economic plan.

As for economic policy, the Rwandan government stands for a liberal planning system where even the public enterprise should, within certain limitations, be answerable for profit-making objectives. This policy is linked with the willingness of the government to rid itself of already existing industrial enterprises which have not attained, up to the present, a financial balance. Rwanda is evolving, step by step, toward the abandonment of the system of subsidizing public enterprises and toward the installation of competitiveness between the private and the public sector. It is thus hoped to achieve a better utilization of Rwanda's rather limited resources.

The scarcity of resources is seen essentially in the feebleness of the gross national income. The amount of savings (8% of GNP) as well as investment (23% of GNP) are, as a consequence, rather low. The weakness of the industrial infrastructure and the service sector on the one hand and the preponderance of the agricultural sector, which dominates subsistence production, on the other hand, explains the stagnation which has hobbled the Rwandan economy for a long time.

The economy is not only weak, it is also vulnerable. Dominated by the agricultural sector from which come more than 70% of export receipts, the economy experiences frequent fluctuations which affect the price of exported agricultural products (principally coffee) and the money supply. From these fluctuations there results a disequilibrium in the balance of trade, in chronic deficit, and a strong dependency vis-a-vis foreign aid. The result is, also, a very rigorous monetary policy where foreign exchange, strictly controlled, is done solely through approved banks with the preliminary and obligatory authorization of the National Bank (B.N.R.). Nevertheless, foreign investors benefit, in this domain as in many others, from sufficient facilities guaranteed by the legislation in force.

III. THE SYSTEM OF INCOME TAX ASSESSMENT

A. Introduction

Rwanda has a "schedular" income tax system which is a revival of the system in effect prior to 1962 which was in use in the Belgian Congo and Rwanda-Urundi: a system largely taken from the Belgian tax system of the period, from which it differs little.[1]

Thus income is not taxed in the aggregate, but it is rather divided into several distinct fragments (schedules) according to economic origin, each of which is taxed at a different rate. We can thus distinguish 3 essential categories of taxes on income: a tax on rental income from which the economic source is determined by real property put out for rental; a tax on income from movable capital with respect to funds invested in Rwanda and a tax on income from the exercise of a lucrative activity.

To be taxable the income, from whatever source, must be produced in Rwanda. The nationality of the beneficiary is immaterial for tax purposes. Nor is income produced outside Rwanda taken into account for liability to taxation. The Rwandan tax system, like other tax systems in developing countries, does not impose tax on world-wide income as do industrial nations.

B. Delimitation of each income tax base

1. Rental income: income originating from income from real property

The basis for the rental income tax is solely through the rental of buildings and similar income from the same sources; e.g. profits on sub-leases and housing allowances given to salaried employees occupying their own homes. The housing allowance is a cash payment made to certain employee-home-owners by the employer who generally assures, as a fringe benefit, free housing.

Rental inocme is taxed in relation to the rent received and the real charges (costs) which encumber it. The personal situation of the receiver (income beneficiary) is never taken into account in the assessment procedure. Note that the tax is levied, on *effective* income, that which has been actually received on rental buildings.[2]

Hidden or psychological income taxation, that is, the imposition of the satisfaction the owner is supposed to experience by the fact of living in his own home or the fact of developing his own land, does not exist as such in Rwanda.

2. Movable capital income tax: income from securities, loans, debt-bonds, etc.

The movable capital income tax is, among other things, imposed on profit distributions by enterprises established in Rwanda. It is also applied to income from business debts; interest on bond-debts and other debts of a business character (income from deposit accounts, proceeds from security bonds and current running accounts). Income from debts for which a business character is not established are not taxed by the movable capital income tax as, for instance, interest on capital borrowed by individuals for private use; to construct a home, for example.

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[1] See Goldsmith, J., "Les impôts sur les revenus au Congo comparés aux impôts belges sur les revenus" (Income Taxation in the Congo Compared to Belgian Income Taxation), Brussels, éditions Jaric s.d. (1954). It should be noted however, that since 1962 Belgium assesses total income having abandoned the previous schedular system.

[2] *Editor's note:* In some countries – including Belgium – tax is levied on an estimated amount, i.e. the "cadastral income".

However, the above income is *not* subject to tax except in the case where it benefits individuals or legal entities not permanently established in Rwanda. Thus, entities established in Rwanda (whether created under Rwandan or foreign law) are exempt from the tax. They may, however, be subject to the income tax with respect to such income when they show a profit in the balance statement.

Income on capital borrowed by the public authorities (the State, subordinate authorities, public establishments) is excluded from movable capital income taxation as are certain establishments, institutions or organizations of public interest as well as States and foreign organizations, including certain mixed public establishments created by them in collaboration with the Rwandan State.

3. Tax on earned income: income from profitable activities

Tax on earned income is assessed on income from the exercise of a profitable activity. The activity giving rise to taxation must be on-going and repetitive in a manner such as to constitute a "profession". The law does not always furnish a legal and precise definition of "profession". All income is, without distinction, subject to the tax, so long as it is established that it comes from a profitable occupation.

However, depending on the nature of the activity, four large categories of income may be distinguished: (1) remuneration of persons paid by a third party, such as a salary or a pension, (2) industrial and commercial profits, (3) profits from professions, and the like, (4) profits from other non-denominated occupations.

C. Tax on rental income

1. Assessment of taxable rental income

Taxable rental income is *net* income. It is the difference between gross income and the costs assignable to the rented property which normally encumber profits. The calculation of net income thus proceeds from an assessment of gross income and deductible costs.

a. *Assessment of gross income*

Gross rental income consists of the amount of rent augmented by the sum of the expenses normally incumbrant on the owner but borne in fact by the tenant, such as personal taxes on rented furnishings, the costs of major repairs and other expenses that law and custom place as a duty on the lessor. An expense once made is spread over the year remaining on the lease.

b. *Deduction of expenses in view of calculating net income*

Two categories of expenses may encumber gross income: the expenses of operating the buildings put up for rent and which encumber the owner by virtue of law and custom, and the sums earmarked for the repayment of a loan contracted with interest or other finance charges.

Deductible operating expenses of rental buildings are deemed to be 20% of gross income.

As for finance charges, i.e. that part of income used to pay interest on capital borrowed for the acquisition of rental property, deductibility is subject to certain restrictions. A deduction is, in effect, not permitted except in the case where the rent is transferred to reimburse the debt contracted. In all other cases, where the rent is not transferred, that is, when the owner is able to reimburse the debt by means other than transferral of rent payments, the deduction of interest is not allowed.

Moreover, for the taxpayers who are able to benefit from the deduction, the amount is a flat fixed 12% of that part of the borrowed amount remaining to be paid.[3]

2. The applicable rate

Net rental income calculated in the above described manner is subject, in its entirety, to tax at progressive rates.

The progression technique employed is progression by income bracket, i.e. the amount of taxable income is split into brackets and to each one of which is applied a more and more elevated rate progressively as one attains the higher brackets. At each bracket, one applies the corresponding rate. The total assessment is equal to the sum of assessments due for each bracket. The rates currently in force date back to the Decree-Law of 17 June 1983 and are as follows:
20% for the bracket less than 200,000 Frs.
25% for the bracket 200,000 to 400,000 Frs.
30% for the bracket 400,000 to 600,000 Frs.
35% for the bracket 600,000 to 800,000 Frs.
40% for the bracket 800,000 to 1,000,000 Frs.
45% for the bracket 1,000,000 to 2,000,000 Frs.
50% for the bracket above 2,000,000 Frs.

D. Movable capital income tax

1. Assessment of taxable income

The taxable amount on movable capital income is gross income less any expenses incurred by the beneficiary to acquire or maintain it. However, even when the investment was made with borrowed capital, that part set aside for the payment of interest is considered as serving the *assignment* of income and not its acquisition or maintenance. Consequently, to obtain the *net* taxable amount, it is normally sufficient to determine *gross* income. Two assessment methods exist: one on actual earned income when the company subject to tax falls under Rwandan law, and the other a presumptive income when it is a foreign company merely having an establishment in Rwanda.

a. *Actual income assessment in companies subject to Rwandan law*

In Rwandan companies, the income taxable is the ac-

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[3] See Art. 1 of Decree-Law of 17 June 1981 (Official Journal August 1981, No. 15, p.689).

tual amount received. This may consist of two very distinct categories of income and profits:

a) income from investments producing a fixed income such as interest on loans in "sociétés de personnes" (including general partnerships, limited partnerships and the like); income from debentures; business loans on joint stock companies; interest, premiums and "lottery prizes" paid to holders of bonds.[4]

b) "variable" movable income which consists of profits distributed by joint stock companies whether from shares or reimbursement of capital through profits and sums allocated to the board of directors and gains and profits belonging to inactive associates in "sociétés de personnes".

b. *Fixed rate assessments in Rwandan establishments of foreign enterprises*

In case of companies falling under national law, movable capital income tax is generally due when income is put at the effective disposal of its beneficiary. In Rwandan establishments of foreign enterprises on the contrary, the actual distribution of profits is not necessary, it is presumed. There follows therefrom a tax on presumptive income to establish taxable income, one takes the actual profit of the establishment subject to tax, the direct source of income attributable to shareholders or by establishing an obligatory relationship between the taxable movable capital income and the net profits imposed by the business tax. The movable capital income tax is thus established on an amount equal to 50% of profits imposed by the business tax (40% representing income distributed on shares and 10% directors' fees (tantièmes) and attendance fees allocated to the board of directors of joint stock companies).[5]

2. Applicable rate

Although rental income and earned income are subject to a progressive rate, income from movable capital is subject to flat rate taxation. This comes to, for each taxpayer, 20% of the amount of his movable capital income.

E. Tax on earned income

1. Assessment of actual income

Whatever the nature of the business, the sector of activity, where it is exercised, or the legal nature of the person on which tax is levied, the same considerations preside over the calculation of net income: it is equal to the difference between gross profits, augmented by miscellaneous profits and capital gains, and expenses incurred by the enterprise or business. From this the assessment of taxable profits consists of distinguishing between the calculation of profits and of business expenses. Two methods of assessment are applied: the principal method is based on actual income and a secondary one on a presumption income depending on the sector of activity or the category of income. Also, distinction is made between industrial and commercial profits, and remunerations and profits from non-commercial businesses.

a. *Assessment of industrial and commercial profits*[6]

Taxable industrial and commercial profits are assessed, for individual businesses as well as for companies, on the difference between the value of the net assets at the beginning and the end of the fiscal year. This includes profits and losses resulting from operations of all types carried out by the enterprise, ordinary as well as exceptional. This also includes capital gains on the transfer of assets as well as funds withheld by the entrepreneur for the maintenance of his family or for any other reason.

(i) *Actual earned income assessment*

– Gross profits:

Actual gross profits are furnished by the financial records of the business. They are the difference between sales, increased by the value of stock at the end of the accounting period and the sum of purchases as increased by the value of stock at the beginning of the accounting period. In industrial enterprises, manufacturing and labour costs are added to purchases.

In gross profits, one likewise includes the value of merchandise withheld by the entrepreneur for his own use, capital gains and all other gains occassioned by sale or transfer as made by the business during the accounting year,[7] interest and royalties received for sales and licensing of patent rights and indemnities for damages awarded for total cessation of an activity or for cancellation of a contract.[8]

The amount thus obtained is reduced by losses (including capital losses) sustained during the three previous years increased by the amount of income already taxed, such as rental income or movable capital.

– Business expenses:

The expenses which may be deducted from gross profits are those which the enterprise can show to have been made or borne during the taxable period with a view to acquiring or conserving the income. This criterion permits – except in case of fraud – to eliminate personal expenses of the entrepreneur. Business expenses can be grouped in two main categories: running expenses and capital expenditure.

Running expenses are expenses necessary to assure the general running of the enterprise. They are deductible from gross income so long as directly necessary to the business. Running expenses are the general expenses, including expenses related to premises, material, per-

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[4] Income from debt-bonds is subject only to movable capital taxation. It is exempt from tax on earned income unlike profits distributed to shareholders and inactive associates which are subject to tax within the company before distribution.

[5] See Art. 14 of Law of 2 June 1964 concerning Income Taxes.

[6] Subject to tax on earned income in the same manner as industrial and commercial profits are profits from handicraft businesses, agriculture and real estate, profits and remunerations of active associates in companies other than joint stock companies, rental profits from tenant-farming, utilization and transfer of all real estate in Rwanda, so long as the latter does not form an accessory to rented real estate for which profits are subject to the tax on rental income.

[7] Non-realized capital gains simply expressed in the account books are not included in gross profits. They are exempt from taxation.

[8] See Art. 32, Law of 2 June 1964.

sonnel and office or warehouse space and financial expenses, such as interest on capital borrowed for the benefit of the business and insurance premiums.

There are, however, certain expenses necessary to the running of the business which are not deductible and which are compulsorily included in gross profits. They constitute, in effect, more a use of income than an expense made in order to acquire it: for example, remunerations that the entrepreneur claims or amounts which are paid to his benefit; also, sums set aside for the refund of capital borrowed for expansion of the business; reserves of all kinds including those to meet contingent liabilities ("provisions"), salaries, and fringe benefits of the associates in "sociétés de personnes", and the benefits a foreign enterprise draws directly or indirectly from associated Rwandan establishments.[9]

Deductible capital expenses include provable monetary depreciation of goods used in the business. The law does not, however, provide for the applicable rates of depreciation. In principle, businesses have a wide discretion to fix the rate of depreciation of their capital assets. Nevertheless, the rates used must be usual and coincide with the actual depreciation sustained during the taxable period.[10] Taking into account the rate of depreciation normally and usually applied in business, the tax administration, itself, fixes the maximum rates fiscally admissable. These are, to cite a few examples, from 5% for buildings in non-durable material and movable and fixed property (machinery), 20% for office or shop equipment and 30% for rolling stock and small tooling.

(ii) *Assessment on presumptive income*

Taxation on a presumptive income is only applicable to taxpayers who do not keep regular accounts and for whom profits do not exceed 600,000 Frs.[11] The assessment methods are determined by the Minister of Finance.[12]

Taxable business profits are fixed in relation to certain indicators of activity. Four indicators, each of which relates to a determined amount of net profits, fix the bases of the estimated income: the surface area of building premises, the demographic importance of the agglomeration where they are located, material from which constructed and the horsepower and the use made (transport of persons, transport of merchandise) of those business vehicles not used to transport third persons.

b. *Assessment of remunerations*

Two categories of income fall under the heading of remunerations, remunerations strictly speaking, and pensions and life annuities.

(i) *Remunerations*

Remunerations, strictly speaking, include all payments, in money or in kind, which a person receives for any labor that benefits a third party, whether through a service contract or employment. Fixed sums, like pensions, salaries and emoluments are variable. Others may be variable when in the form of output or end of year bonuses. Or they may be compensation of all kinds, lodging allowances and others, which are not reimbursement of effective business expenses, but rather a salary supplement. Family allowances and legal indemnities are tax exempt.

(ii) *Pensions, etc.*

The category of taxable pensions is uniquely that of retirement pensions issued by the State through the Social Fund (Caisse Sociale) of Rwanda. Old-age pensions, alimonies, pensions for invalids, widows, orphans and parents of soldiers, life annuities and allocations to victims of accidents at work, workmen's compensation and for job related illness are all exempt.

(iii) *Deductible expenses*

The only expenses deductible from the gross amount of remunerations are payments by the employee toward a pension, life annuity, health or unemployment insurance.[13] Other expenses, such as office expenses, travel and transport are rarely deductible.

C. *Assessment of non-commercial profits*

(i) Assessment of gross profits

Assessments of non-commercial profits are made according to the same procedure as that for industrial and commercial profits. The amount of profits taxable is, in principle, determined according to the elements that the taxpayer, himself, enters in his declaration. They are equal to the difference between total receipts and expenses actually paid. The receipts include, as well as the profits from the activity, the profits and gains from the sale of products serving as the purpose for the activity. When the accuracy of the declaration cannot be proved, it is subject to administrative evaluation. In this case, the amount of profits taxable is established through a comparison with profits from similar taxpayers,[14] either by taking into account all the elements likely to reveal the existence of profits higher than the declared amount, such as invested capital, sales, number of sales points, number of employees working on the project and all other useful information.[15]

(ii) *Deductible expenses*

For expenses and outlays, the law is the same as for the industrial and commercial profits. Profit declarations must be supported by justifying documentation, and if not, are subject to assessments of 25% of receipts up to a maximum of 300,000 Frs.[16]

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[9] Id. Art. 41.

[10] Id. Art. 43, 8°.

[11] See Art. 1 of Decree-Law of 28 December 1973 modifying the Law of 2 June 1964 (Official Journal of 1 April 1974, No. 4).

[12] Taxation on a presumptive income was organized by Ministerial Decree No. 10/071 December 1973; measures to execute the Law of 2 June 1964 concerning taxes on income (Official Journal No. 8 of 15 April 1974).

[13] See Art. 50, Law of 2 June 1964.

[14] The law does not specify the methods of evaluating the taxable profits through comparison. These are left to the discretion of the Administration.

[15] Id. Art. 33.

[16] Id. Art. 57.

d. *Personal expenses deductible from net income of individuals*

For reasons of public policy, certain personal expenses not connected with earned income are deductible from the net income of individuals. However, the law and regulatory measures concerning these deductions place limitations on these deductions.

Deductible from net income are:[17]

- Outlays made by the taxpayer for his personal benefit, through a life annuity, pension, health or unemployment insurance, up to 20% of the amount of earned income taxed the previous year, not to exceed 36,000 Frs.
- Gifts made to charitable institutions for the benefit of Rwandan nationals, up to a maximum of 10,000 Frs.[18]
- Transportation costs of the taxpayer and his family for holiday after expiration of at least a 2-year period in Rwanda.
- Medical expenses of the taxpayer and his dependants.

2. Applicable rate

a. *General rate*

With respect to taxes on earned income, there is a progressive rate as on rental income. Furthermore, a distinction is made based on the legal character of the taxpayer such that different rates are levied according to whether the beneficiary of taxable income is an individual or a legal entity.

Individuals
0% for that part below 60,000 Frs.
10% for that part from 60,000 to 100,000 Frs.
14% for that part from 100,000 to 200,000 Frs.
18% for that part from 200,000 to 300,000 Frs.
22% for that part from 300,000 to 400,000 Frs.
26% for that part from 400,000 to 500,000 Frs.
30% for that part from 500,000 to 600,000 Frs.
34% for that part from 600,000 to 700,000 Frs.
37% for that part from 700,000 to 800,000 Frs.
40% for that part from 800,000 to 1,000,000 Frs.
45% for that part from 1,000,000 to 2,000,000 Frs.
50% for that part over 2,000,000 Frs.

Corporations
20% for that part below 250,000 Frs.
25% for that part from 250,000 to 400,000 Frs.
35% for that part from 400,000 to 700,000 Frs.
40% for that part from 700,000 to 1,000,000 Frs.
45% for that part from 1,000,000 to 2,000,000 Frs.
50% for that part above 2,000,000 Frs.

b. *Tax reductions for married taxpayers*

A reduction in earned income tax is given to married taxpayers for family expenses. The reduction is 5% of the tax normally due for each dependant: spouse, ascendants, spouses' parents living in the household, unmarried children born of one or more monogamous marriages and for whom existence at beginning of the year can be proved.[19] These persons are not, however, considered as dependants if they have personally obtained an income during the preceding year, which surpasses 25% of the taxpayer's income up to a maximum of 15,000 Frs.[20]

However, the tax reduction is not computed on the total earned income tax. It is only permitted on that percentage of the tax relating to income inferior to 300,000 Frs. In other words, the tax reduction is limited to 1,800 Frs. for each dependant.[21]

3. Business tax

a. *In general*

The business tax (droit de patente) is a recently instituted tax in Rwanda.[22] It does not constitute, in itself, a separate tax because it does not have its own tax base. It is rather a complement to the earned income tax, which tends toward the attenuation of the inadaptibility and the insufficiency of the techniques of income assessment founded on the self-assessed declaration.

The business tax is a presumptive (forfaitaire) amount payable at the beginning of the year by every person or enterprise carrying on a commercial, industrial, craft or professional activity. It is credited against the earned income tax due the same year but is rarely refundable when assessed above the earned income tax normally due.

b. *Applicable rate*

The rate of the business tax varies in relation to the nature and size of the activity as well as the category to which a taxpayer subject to the tax belongs (for individuals only).

(i) *Rate of business tax for commercial and craft activities of individuals and for individuals carrying on a "liberal profession"*

Category of taxpayer	*Rate by locality (in Rwandan Frs.)*			
	Urban district of Kigali	*Other urban districts*	*Commercial centers*	*Trade centers and elsewhere*
Retail craftsmen without a shop	4,500	3,000	2,250	1,500
Retail tradesmen without shops	6,750	4,500	3,375	2,250
Retail craftsmen and tradesmen with temporary shops	13,500	9,000	6,750	4,500
Retail craftsmen and tradesmen with semi-permanent or permanent shops	45,000	30,000	22,500	15,000
Semi-wholesalers and persons carrying on a liberal profession	90,000	60,000	45,000	30,000
Wholesalers, importers, exporters and industrialists	225,000	150,000	112,500	75,000

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17. Id. Art. 44.
18. Art. 3 Ministerial Decree No. 10/071/fin.
19. See Art. 90, Law of 2 June 1964.
20. See Art. 19, Decree-Law of 19 June 1984.
21. Id. Art. 18.
22. See Decree-Law No. 11/81 of 19 June 1981 (Official Journal 1981, No. 12.3, p.1-5).

(ii) *Rate of business tax on passenger transport activities*

For the first year of business, there is no tax. For the second year, the tax is equal to 3% of the value of acquisition of the means of transport in a new condition. It is thereafter 3% of 90% of the above value.

(iii)*Rate of business tax on corporations*

For corporations (excluding public, i.e. State-owned entities), whatever their activity, the business licence is equal to 3% of invested capital, with a minimum which cannot be inferior to the rate to which individuals in the same category are subjected.

F. Special provisions, in favour of investments

1. Introduction

The income tax scheme described in this article is the general scheme applicable to all Rwandan-source income. But alongside the general scheme there exists a special tax treatment reserved to income investments considered of prime importance (prioritaire) and of benefit to the economic development of the country. The relative provisions are appended to the Investment Code[23] and apply to indirect tax as well as direct tax. We limit our discussion here to fiscal privileges applicable to direct taxes on income.

2. Businesses which may benefit from privileged tax treatment

The law enumerates, in a long list, the character of priority enterprises to which these tax privileges are granted. These are notably the following:

1) real estate businesses;
2) industrial enterprises that prepare and process animal and vegetable products;
3) enterprises that process raw materials;
4) fertilizer production plants;
5) enterprises of an industrial nature that incorporate an additional stage of production or packaging;
6) enterprises that manufacture or assemble articles, objects and products (textiles, construction materials, metal construction, vehicles, clinical and pharmaceutical products, paper and pasteboard);
7) enterprises for the treatment of hydrocarbons and oil industry research;
8) fishing businesses;
9) hotel and tourist businesses;
10) enterprises for the production and transport of electrical energy;
11) financial institutions.

Depending on the nature and size of the investment, the code provides two different benefit schemes; the agreement scheme and the special contract scheme.

3. The agreement scheme

a. *Beneficiaries*

Rwandan as well as foreign enterprises may benefit from the agreement scheme. To be eligible to participate in this plan, Rwandan enterprises must show invested capital of at least 10,000,000 Frs. and foreign enterprises 20,000,000 Frs.

b. *Privileges concerning income tax*

Enterprises participating in the agreement scheme benefit from an exemption from payment of taxes on profits (earned income tax) for the first 5 years of operation. Thereafter, taxes must be paid but only in a progressive manner: only 1/3 of taxes due are paid the first year, 2/3 the second year and it is only as of the third year that they are paid in their entirety.

4. The special contract scheme

a. *Beneficiaries*

Given the considerable extent of benefits concerned, the special contract plan is only available in truly exceptional cases. In effect, it is only open to enterprises considered especially important for national development, having a considerable volume of investments and necessitating a long operating period before a normal return on invested capital can be expected.

b. *Privileges concerning income tax*

Participating enterprises enjoy, firstly, all the benefits accorded by the agreement scheme. In addition, they benefit from:

- stabilisation (i.e. "freezing") of the tax regime for 15 years with possibility of a prolongation of 5 years for projects having an exceptionally long operating period before completion;
- the possibility of revising tax conditions every 5 years;
- finally, a reduction of the taxable base for purposes of the earned income tax equal to a certain percentage (20% + 50%) of profits effectively reinvested in Rwanda during the course of the scheme, either directly or by intermediary of other corporations of which the participating company is a shareholder, for the realization of approved profjects.

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[23] See Decree-Law of 21 September 1977 (Official Journal 1977, No. 19, p.420).

INDIA:

Budget 1985-86

By Kailash C. Khanna

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No Finance Minister has ever lost popularity by announcing tax reliefs and concessions, particularly if these relate to direct taxes. It is not surprising therefore, that India's Finance Minister, Mr. V.P. Singh, has won kudos for his tax proposals contained in the Finance Bill introduced in Parliament on 16th March, even though the direct beneficiaries of his munificence will constitute less than 0.6% of the country's population.[1]

It was in the year 1957 that the structure of direct taxation in India was modified, ostensibly, on the advice of Professor Nicholas Kaldor. But to be fair to the Professor, some of his suggestions were tampered with, the bane of most tax advisers; for instance, tax rates were not lowered to the levels he suggested. Two new taxes on wealth and on expenditure were introduced. The tax on wealth was proclaimed to be a measure which was "egalitarian in intent" but which did not have a "disincentive effect". The tax on expenditure was hailed as "a potent instrument for restraining ostentatious expenditure and for promoting savings." A year later, in 1958, a tax on gifts was imposed "to fill a gap in the scheme of direct taxation" and "to make evasion or avoidance difficult". With an estate duty already in existence, the different taxes were intended to provide an integrated whole which would be self-checking.

Apparently, there was no escape from the tax drag net; if one earned too much, he would pay higher income tax; if he spent too much he would pay expenditure tax; if he did not spend but accumulated wealth he would pay wealth tax, if he gifted away his possessions he would be liable to gift tax; and if he did nothing of the sort and died leaving behind a mass of wealth his estate would pay heavy death duties.

Economic growth with social justice seemed near at hand!

But over the years, incorrigible tax dodgers, inefficient and indulgent tax collectors, unethical political influences and inherent human greed have spelt the doom of the so called self-checking system. Because of inborn deficiencies and incompetent treatment, the expenditure tax was a victim of infantile mortality. The estate duty has been a paralysed impost and is about to suffer a fatal stroke because, according to the Finance Minister, it has not lived up to its expectations of reducing unequal distribution of wealth. Possibly, for a somewhat similar reason, wealth tax too is likely to be crippled soon. The gift tax, in any case, has been a listless levy. Confiscatory rates of taxation have led to proliferation of black money and the existence of a parallel economy. Accelerated economic development and an egalitarian society have remained beyond reach.

Against this background, the direct tax proposals contained in the Finance Bill are undoubtedly praiseworthy, innovative and courageous. After the lapse of almost 3 decades, it seems to have been realised that harsh taxation by itself alone cannot achieve both the objectives of rapid economic growth and a socialistic pattern of society. The suggested modifications to the tax structure, if adopted, will usher in a new era of fiscal policy, moving away from ideology and dogma to reality and pragmatism. The schedule of personal taxation is proposed to be revised, reducing the tax slabs from nine to four, abolishing the 12.5% surcharge on income tax and bringing down the maximum marginal rate from 61.875% to 50%.

The proposed rate structure is:

Income slab	*Proposed tax rate*
a) Up to Rs. 18,000	nil
b) Rs. 18,001 to 25,000	25%
c) Rs. 25,001 to 50,000	30%
d) Rs. 50,001 to 100,000	40%
e) Over Rs. 100,000	50%

Although the calculated loss of revenue due to the proposed reduction in personal taxes is estimated at around four billion Rs., the Finance Minister is optimistic that about half of this loss will be made good through better tax compliance. One can only hope that this optimism is justified though there is no convincing evidence; the results will be watched with considerable interest.

The rate structure of wealth tax is also proposed to be revised, raising the tax exemption limit to Rs. 250,000, providing a nil rate slab for net wealth up to Rs. 250,000 and bringing down the maximum marginal rate from 5% to 2%.

The suggested schedule is:

Amount of wealth	*Proposed tax rate*
a) Up to Rs. 250,000	Nil
b) Rs. 250,000 to 1,000,000	½%
c) Rs. 1,000,001 to 2,000,000	1%
d) Over Rs. 2,000,000	2%

Here again the Finance Minister does not anticipate any loss of revenue because of improved compliance. Instead of separate existing exemptions in respect of a residential house, investments in specified assets and units of the Unit Trusts of India, aggregating Rs. 500,000, it is proposed to provide a consolidated exemption of an equivalent sum of Rs. 500,000 in respect of all these assets. The scheme of compulsory de-

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[1] Approximately 4,000,000 people receive a tax assessment. There are several reasons for this:
(i) about 70% of the population derives income from agriculture which is not liable to income tax;
(ii) a large proportion of the non-agricultural income earners are living on, if not below, the poverty line;
(iii) the tax administration is inefficient and inadequate. Proprietary concerns, small shopkeepers, self-employed individuals and others, unfortunately, have little regard for the tax laws and treat the tax administration with contempt.

posits by income tax payers is being abolished from 1 April 1985, but the repayment of instalments in respect of earlier deposits is being withheld for a year. The proposed abolition was one of the items promised in the election manifesto of the ruling party but the postponement of the repayments has aroused considerable protest.

As a measure of relief to industrial workers, it is proposed to raise the monetary ceiling of exemption from tax of retrenchment (redundancy) compensation from Rs. 20,000 to Rs. 50,000; in the case of compensation paid under a Government approved scheme, the entire amount will be tax free. At present salaried taxpayers are chargeable to tax on the perquisite represented by interest-free loan or loans at concessional rates of interest given by the employers for specific purposes. It is proposed to repeal this provision. Further, under the existing provisions, employees lose the benefit of a standard deduction from salary income in case they are provided transport by their employers from residence to the place of work and back. This restriction is proposed to be withdrawn. These are welcome measures for those who pay their tax through deduction at source.

In order to provide impetus to local scientific research, it is intended that lump sum consideration received by a scientist for know-how developed by him should be liable to tax spread over a period of 3 years. Linked with this is the proposal to permit the write-off of the lump sum consideration paid for acquiring know-how in 6 annual instalments. A shorter period of write-off of 3 years would be allowed where the know-how has been developed in Government owned companies and scientific laboratories or universities.

In the sphere of corporate taxation, it is intended to reduce the basic rate of income tax applicable to all categories of widely-held domestic companies by 5 percentage points from 55% to 50%. For all closely-held companies a common rate of 55% is proposed instead of the existing rates of 60% and 65%, the only exception being closely-held trading and investment companies to which a higher rate of 60% will be applicable. The rationale of this exception is not clear and it has been represented that the benefit of the lower tax rate should be given to these companies also.

It may be mentioned here that the proposed corporate tax structure seems somewhat unscientific and does not appear to be in conformity with the general principle of taxation under which the maximum rate of tax applicable to company profits is ordinarily lower than the maximum marginal rate of personal income tax, especially under the classical system of corporate taxation which is in force in India. Moreover, if tax on closely-held companies is much higher than that payable by individuals, there is a distinct disincentive to the adoption of the corporate form of business which is otherwise highly desirable from the point of better tax assessment and easier collection.

Foreign companies will pay tax at the rate of 65% instead of the existing 70%. The surcharge on corporate tax will be continued although companies will retain the option of depositing an equivalent sum with the Industrial Development Bank in lieu of surcharge.

An incongruous suggestion in regard to corporate tax rates seems to have inadvertently crept into the Finance Bill. Instead of reducing the tax rate on long-term capital gains made by companies, it is proposed to raise the tax from 40% to 50% on long-term capital gains made by small companies in relation to buildings and lands or rights therein. For all other companies the existing rates of 50%, and 40%, depending on the type of capital asset, are being kept intact. Surely, this is against accepted canons of tax policy; long-term capital gains must be taxed at rates lower than those applicable to ordinary profits. A reduction of 5%, if not more, commensurate with the Finance Minister's declared objective, must be effected by a suitable amendment of section 115 of the Income-tax Act.

An innovation, so far as Indian Budgets are concerned, is the Finance Minister's indication as to what he would like to do in regard to corporate tax rates during the next 2 years. It has been suggested that the basic rate of income tax in the case of all types of companies be further reduced by 5 percentage points in the next year. In the third year, it is intended to discontinue the surcharge on income tax payable by all companies and also to abolish the surtax on company profits. Simultaneously, the Finance Minister proposes to phase out the grant of investment allowance over the next 2 years. Alternatively, the investment allowance will continue and so will the rates of corporate taxation suggested in the Finance Bill. Mr. V.P. Singh has asked for the reactions of industry and taxpayers through comments by Members of Parliament in order to arrive at a final decision.

Certain amendments have been proposed in the computation of the taxable profits and gains of business. Some of these pertain to the relaxation of existing restrictions while others withdraw the prevailing deductions. Additional depreciation in respect of machinery and plant is intended to be withdrawn. Likewise, the deduction in respect of rural development is suggested to be discontinued. The tax exemption granted to profits derived from the publication of books will not be carried further and dividends received by Indian companies from certain foreign companies will no longer enjoy a tax concession.

At present interest payable on moneys borrowed for payment of tax is allowed as a deduction in computation of taxable income; it is intended to withdraw this deduction. Expenditure incurred by taxpayers in respect of any proceedings before any income tax authority for determination of any tax liability under the Income-tax Act is currently allowed to be deducted up to a maximum of Rs. 5,000. It is proposed that no deduction of this nature shall be allowed at all unless the representative is an employee of the taxpayer. This suggestion will cause hardship to small taxpayers who can ill afford to employ a full time tax expert and who will invariably need the services of a specialist at the time of assessment.

On the other hand, the tax holiday available to specified industrial undertakings, hotels, and ships is proposed to be extended for a further period of 5 years. Exporters will henceforward be entitled to a deduction of an amount not exceeding 50% of their export profits, provided the said profits are credited to a reserve account to be utilised for the purpose of the business. Export profits will be calculated on the basis of the proportion which the export turnover bears to the total turnover, in case the entire turnover does not relate to exports.

Mr. V.P. Singh's advisers are apparently confused in regard to the tax concession to be granted to the exporters. The Finance Act of 1982 introduced a new section 89A stipulating a tax benefit based on turnover, subject to a ceiling of 10% of the income tax payable on export profits. It was represented that exports hardly yielded any profits; in any case, such profits were nominal. Consequently, a tax benefit restricted to 10% of the tax payable on export profits would be illusory. Recognising the validity of the representations, the Finance Act of 1983 omitted section 89A with immediate effect and instead introduced a new section 80 HHC whereby the tax benefit was granted on the basis of existing and incremental export turnover. Curiously, the Finance Bill of 1985 again seeks to link the tax benefit to profits on exports. Considering that exports are made on a very competitive basis in the international market and these seldom yield adequate profits, it is inadvisable to link the tax benefit to export profits. The proposed amendment should be dropped.

At present 20% of the expenditure, in excess of Rs. 100,000 on advertisement, publicity, and sales promotion; running and maintenance of aircraft and motor cars; and payments made to hotels, is added back to taxable income. It is now proposed to delete this addition. Further, 15% of the interest paid by non-banking non-finance companies on the public deposits raised by them is at present disallowed in the computation of taxable profits; this provision is also intended to be withdrawn. These are helpful proposals which will bring real profits closer to taxable income.

Companies engaged in the business of growing and manufacturing tea in India will be entitled to a deduction of up to 20% of their profits provided these are deposited in a special account with the National Bank of Agricultural and Rural Development. Withdrawals from this account will be allowed in connection with a scheme approved by the Tea Board.

Although strictly not within the ambit of taxation, it is intended to permit companies to make donations to political parties. A number of companies are proposed to be taken out of the clutches of the Monopolies and Restrictive Trade Practices Act, licensing regulations and controls.

The major criticism against the Finance Minister's budget proposals is that he has left a huge uncovered deficit of Rs. 3,349 crores (1 crore = 10 million) which may rise further. This, coupled with the imposition of additional customs and excise duties and the hike in the railway fares and freight may spur inflation. The Finance Ministry officials are sanguine that, with the changes in the tax structure and removal of restrictions on production and expansion, the boost in the economy will neutralise the possible effects of a yawning deficit; accordingly it is a risk worth taking. "A riskless budget would have been a listless budget", quipped the Finance Minister in his reply during the Budget debate in Parliament.

If the public section undertakings substantially improve productivity, if the private sector industry accelerates full utilisation of capacity, if the monsoon plays fair, if taxpayer compliance improves and if there is stability in the economy, considerable approbation for the bold steps will be justified. However, there is a plethora of 'ifs' and we can only keep our fingers crossed to see whether the break from the shackles of high taxation, excessive licensing and controls yields the coveted objectives.

INDIA: SUMMARY OF TAX PROPOSALS

I. DIRECT TAXES

1. The personal income tax exemption limit is raised to Rs. 18,000 from Rs. 15,000 thus exempting an additional 1,000,000 taxpayers out of 4,000,000 taxpayers.
2. The rate schedule applicable in the case of individuals and Hindu undivided families (other than those having one or more members with income exceeding the exemption limit), unregistered firms, associations of persons and bodies of individuals is being rationalised and restructured.[1]
3. The maximum marginal rate of income tax is to come down from 61.875% to 50% with the abolition of the surcharge of 12.5% in the case of all non-corporate taxpayers.
4. The exemption limit in the case of individuals and Hindu undivided families (other than those having one or more members with independent net wealth exceeding the exemption limit proposed is to be raised to Rs. 250,000 from Rs. 150,000.
5. A nil rate slab is to be provided equal to the exemption limit.
6. The five slabs of wealth tax rates ranging from 0.5% to 5% are to be reduced to 3 ranging from 0.5% to 2%.
7. The maximum marginal rate of wealth tax is to be reduced to 2% from 5%.
8. The wealth tax rate for Hindu undivided families of one or more members with net wealth exceeding the

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[1] The rate schedule for personal income is being restructured from the assessment year 1986-87. After the nil rate slab of Rs. 18,000 the rate of income tax on the slab of Rs. 18,001 to Rs. 25,000 will be 25%; on the slab of Rs. 25,001 to Rs. 50,000, the rate will be 30%; on the slab of Rs. 50,001 to Rs. 100,000 the rate will be 40% and on the slab of Rs. 100,000 and above the rate will be 50%.

exemption limit is proposed to be revised.

9. The estate duty in respect of estates passing on deaths occurring on or after 16 March 1985 is proposed to be abolished through legislation to be introduced.
10. The compulsory deposit scheme will be abolished with effect from 1 April 1985. The repayment of instalments of earlier deposits and payment of interest due in 1985-86 will be postponed by 1 year.
11. In the case of closely-held domestic companies, excepting trading and investment companies, the basic rate of tax will stand reduced by 10 percentage points, from 65% to 55%. Closely-held trading and investment companies will be liable to tax at the basic rate of 60%.
12. The rate of corporate tax in the case of widely-held domestic companies will be reduced from 55% to 50%. In the case of a foreign company, the basic rate of tax is proposed to be reduced from the existing 70% to 65%.
13. Sportsmen winning awards in international contests will get tax concessions.
14. The surcharge on income tax in the case of companies is proposed to be continued.
15. The monetary ceiling on the exempt amount of retrenchment (redundancy) compensation under the Industrial Disputes Act will be raised from Rs. 20,000 to Rs. 50,000. The limit will not apply in cases where the compensation is paid under any scheme approved by the central government.

16. Under a provision of the laws, salaried taxpayers are chargeable to tax on the perquisites represented by interest free loans or loans at reduced rates of interest provided by their employers for building houses or purchasing a site or a house and site or for purchasing a motor car. This provision is to be repealed.
17. Exporters will be entitled to a deduction of an amount not exceeding 50% of export profits to be carried to a reserve account for business promotion.
18. Companies engaged in growing and manufacturing tea in the country will be entitled to a deduction of up to 20% of their profits deposited in a special account with the National Bank for Agricultural and Rural Development.
19. The disallowance (i.e. add back) of 20% of expenditure in excess of Rs. 100,000 on advertisement, publicity, and sales promotion, running and maintenance of aircraft and motor cars and payments made to hotels will be discontinued.
20. The lump sum consideration paid for acquiring technical know-how can be written off in 6 annual instalments.
21. The tax holiday concession under section 80-I is extended for another period of 5 years.
22. 100% donation to the Prime Minister's National Relief Fund will be deductible.

II. INDIRECT TAXES

1. The excise duty on black and white TV sets up to 36 cms is abolished.
2. The auxiliary duty on crude petroleum is raised from Rs. 100 to Rs. 300 per tonne to fetch Rs. 620 crores.[2]
3. Computers are completely exempted from excise duty.
4. No customs duty is imposed on advanced types of computers not manufactured in India.
5. The excise duty on commercial vehicles is increased by 5%.
6. Anti-tuberculosis and anti-leprosy drugs are totally exempted from duty.
7. The duty on medical equipment (like scanners) is reduced to 45% ad valorem.
8. The basic rate of excise duty on common varieties of cement is raised from Rs. 205 to Rs. 225 per tonne.
9. A total exemption from duty on import of paper pulp to preserve forests is introduced.
10. The basic excise duty on printing, writing and craft paper is increased by Rs. 200 per tonne.
11. Imported raw hides and skins are fully exempted from duty.
12. Commercial vehicles and passenger cars fitted with turbo charges will enjoy a 2% reduction of excise duty.
13. The customs duty on imports for projects for the power sector is reduced to 25% ad valorem.
14. A total exemption from customs duty on wind-operated equipment is introduced to encourage non-conventional sources of energy.
15. Accessories for bicycles are exempted from excise duty.

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[2] 1 crore = 10 million.

A Summary of Singapore's 1985 Budget

By Lee Fook Hong

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Contents

The Minister for Finance, Dr. Tony Tan, presented Singapore's 1985 Budget to the Parliament of the Republic of Singapore on 8 March 1985. The focus of the Budget was on the business sector. Whilst the Budget offered cost-cutting incentives to businessmen, it penalised taxi-commuters and car owners.

As usual, the Minister's Budget Statement was presented in three sections. In the first section, he gave an overview of Singapore's economy for the last five years and spelt out Singapore's economic policy in the Eighties. In the second section, he dealt with the expenditure budget for financial year 1985. In the final section, the Minister dealt with revenue estimates and elaborated on the tax changes and other tax increases.

I. ECONOMIC PERFORMANCE AND ECONOMIC POLICY

(1) The economy in 1980-84

The following summary of Singapore's economy for the last five years was given by the Minister:

> Notwithstanding the prolonged world recession in 1980-82, the most severe the world has experienced since the Second World War, the last five years have been years of exceptional prosperity for Singapore and Singaporeans. Singapore's gross national product (GNP) grew at an average rate of 8.5% per annum in real terms in the period 1980-84. As a result our per capita GNP increased from $ 9,000 in 1980 to $ 12,000 in 1984 at 1980 prices, a rise of 34%. As a proportion of Japan's 1980 per capita GNP of $ 19,100, Singapore's per capita GNP has risen from 49% in 1980 to 66% in 1984. If we continue to do as well in the next five years as we have in the last five years, we will attain our target of reaching Japan's 1980 per capita GNP before the end of this decade.
>
> Our workers have benefitted substantially from this rapid economic growth. We have had full employment throughout the last five years. The highest unemployment rate during this period was just over 3%. The unemployed mainly comprised those who were in-between jobs or fresh school leavers and University graduates. Unlike the situation in almost every other country in the world, no worker in Singapore has been unable to get a job if he wanted one.
>
> With full employment and rapid economic growth the average earnings of workers in Singapore has increased significantly. After discounting for inflation earnings have increased on average more than 8% per annum over the last five years. Consequently the standard and quality of life of workers in Singapore has improved. More Singaporeans are employed in better-paying and higher skilled jobs. With the setting up of more sophisticated industries and the diversification of our economic activities, the value-added per worker will rise further, particularly for those workers who upgrade their skills.
>
> Despite rapid economic growth we have managed to hold down our inflation at a level which is far lower than that experienced in other countries. The average rate of inflation in Singapore in the last five years was 4.9% in a period when double-digit inflation rates were the rule rather than the exception in many parts of the world. Our low rate of inflation is a direct consequence of our policy of maintaining the free-enterprise open trading system in Singapore so that our traders are able to import our requirements of goods and services from the cheapest suppliers in the world.
>
> Strong economic growth has generated a surplus in the balance of payments every year. The balance of payments rose sharply from $ 1.4 billion in 1980 to $ 3.2 billion in 1984. The Singapore dollar is regarded as one of the soundest currencies in the world.
>
> The strong confidence in Singapore by the international business community is reflected in the healthy level of investment commitments. On the average about $ 1.7 bil-

> lion of investment commitments were made annually in the last five years. These investments provide the cutting edge to upgrade our industries to a higher level of sophistication thereby introducing a new range of skills and products to our economy.

(2) Singapore's economic policy

The Minister then proceeded to spell out Singapore's economic policy in the Eighties. Economic strategies in the light of current and future economic problems were mapped out.

a. The private sector as the engine of growth

With privatisation as the main theme, the Minister said,

> In the 1980s the engine of economic development should be the private sector and not the government. The private sector must be encouraged to set the pace in leading Singapore to a new economic era.
>
> Towards this objective the Ministry of Finance has over the last year conducted a thorough review of government's role in business activities. Following the review the Ministry has decided that the following guidelines should be followed for all government companies, including those which are owned by the statutory boards:
>
> (a) Government will invest in new priority industries only where private entrepreneurs do not have the will or the money to undertake projects on their own or where it is essential for government to provide the entrepreneurship;
> (b) Government will divest its shares in companies where it does not have a majority stake and where it is not essential for government to have effective control;
> (c) Unlisted government companies will, wherever possible, be listed on the Stock Exchange;
> (d) For critical companies which are considered to be vital to the national interest, government will maintain a controlling interest but will invite participation from the public through listing on the Stock Exchange.

b. The problem of labour shortage

The Minister noted that one of the major problems which had hampered the operations of the private sector had been the severe shortage of labour. He cautioned that the solution to this problem could not be an indefinite and ever-growing dependence on foreign workers as such dependence would give rise to social and political problems. However, he assured that repatriation of foreign workers who were already here should be gradual and such repatriation would be administered more flexibly taking into account particularly the needs of manufacturers, hoteliers, shipyards, construction companies and working mothers.

c. Cost of doing business in Singapore

With regard to the cost of wages, the Minister remarked that wages had risen to a level commensurate with the quality of skills of workers and further increases could only be justified if there were corresponding increases in productivity.

He also allayed fears that there would be further increase in the rate of Central Provident Fund (CPF) contributions, currently standing at 50% of wages, half from the employers and half from the employees.

On the rate of contribution to the Skills Development Fund, the Minister said that the SDF levy would be lowered to 2% with effect from 1 April 1985, subject to review after three years.

The Minister noted that the Jurong Town Corporation had decided to freeze its rentals on industrial properties and the Port of Singapore Authority would, in June 1985, revise and simplify its tariffs. He commended these two statutory boards for their good examples of responding sensibly to market forces and urged other statutory boards to follow suit.

d. External constraints on growth

The Minister identified the following external constraints that could have an adverse effect on Singapore's economy:

i. Instability of the world's financial system;
ii. Growth in protectionist sentiment; and
iii. The re-industrialisation drive in the developed countries.

Commenting on the unstable world's financial system and huge U.S. budget deficit, he said that fortunately for Singapore, her ample reserves and sound currency had enabled her to mitigate the worst effects of the currency upheavals.

Of trade protectionism, the Minister explained:

> The danger that protectionism can pose for Singapore can be gauged from the fact that our external trade is more than three times our gross domestic product. What this means is that we are more vulnerable than most other countries to protectionism. Our prosperity depends crucially on our being able to get continued access to overseas markets.
>
> Protectionism affects us adversely in two ways. First, and more obvious, it hinders our exports, particularly our domestic exports, thereby impeding the growth of our domestic industries. Second, growing protectionism encourages multinational companies to invest in countries where the markets are, rather than in countries which can offer more efficient off-shore production.
>
> If we try to combat protectionism by erecting protectionist barriers ourselves, we shall bring perdition upon ourselves. Our free trade policy has served us well and we will continue this policy. But we will have to work through GATT and other international organisations to press the case for a more liberal international trading system or at least to slow down further encroachments on free trade. The government will do its utmost in this field but our exporters must also be more aggressive in their marketing strategies.
>
> Our exporters must search for the right niches in the world market where we can be internationally competitive. We must maintain our flexibility and be adept at adjusting to new developments and changes in our markets. Counter-trade, for example, has become a new feature of international trade. Singapore firms must quickly grasp the complexities of these new arrangements and seize the opportunities that will be thrown up.
>
> The government will draw up appropriate programmes to help our exporters to achieve these objectives. In addition, new entrepreneurial talent will be identified and

> nurtured to become the next generation of Singapore exporters. The Trade Development Board will help Singapore firms to increase their share of traditional markets overseas and to penetrate new markets. The TDB's network of overseas offices will be strengthened and an effective system will be developed to provide Singapore exporters with up-to-date commercial information.

The Minister noted that there had been a disturbing trend in the pattern of investments in Singapore in the last few years as a result of the re-industrialisation drive in the developed countries. He stressed the importance of establishing Singapore as a producer of specialised products and services in order to continue Singapore's economic growth. Also identifying travel and tourism as another area of Singapore's promise, the Minister announced that duty on most categories of entertainments would be significantly reduced from the current rates of 25% and 35%.

e. Land and water

The Minister explained that in view of Singapore's limited land resources, it would be vital to have efficient land utilisation. He said that the most effective way to ensure optimum use of land would be to allow market forces to dictate the allocation and pricing of land. However, he cautioned that the government should never release too much land at any one time so as to create a property slump.

With regard to the present level of development charge, the Minister said that the Government would review whether a lower rate might be more effective in fostering urban development.

The Minister also stressed the need to reduce the rate of growth of Singapore's water demand.

(3) Concluding remarks on economic policy

In conclusion, the Minister reiterated that education and training would be the cornerstone of Singapore's economic upgrading strategy and the key to a better life for the people of Singapore. He said,

> It is this systematic infusion of skilled and trained manpower, added to the pool of existing workers who are upgrading their skills through in-company training, which gives me confidence that our economy will continue to progress and that in due course we shall enter the ranks of the first league of industrialised nations.

II. FINANCIAL YEAR 1985 EXPENDITURE BUDGET

The Minister explained that the Expenditure Budget for Financial Year 1985 emphasised the building up of economic and social infrastructure and a larger provision would be set aside for education and training to expand the pool of skilled, technical and professional manpower.

The Minister then proceeded to elaborate on the expenditure estimates, which are not discussed here.

III. TAXATION

(1) Revenue

The Minister reported that the Consolidated Fund receipts on existing tax rates would be expected to amount to $ 10.62 billion for the Financial Year 1 April 1985 to 31 March 1986, which would represent a marginal increase of 1.6% over the revised estimate for Financial Year 1984.

He expected a decline in income tax collections, the main contributor to revenue, due to anticipated poorer business conditions. However, he said that this decline would be offset by increased collections from property tax, customs and excise duties, interest and dividends and currency surplus.

He further reported that with an expected revenue of $ 3.74 billion from the Development Fund, there would be a deficit of $ 4.47 billion for Financial Year 1985 and this deficit would be financed by borrowings and drawing down from the Development Fund.

(2) Tax changes

The Minister then moved on to tax changes. Extracts of the Minister's speech on tax changes are reproduced below:

(a) Payroll tax and tax on telecoms telephone bills

> In an addendum to the President's address at the Opening of Parliament I stated that one of the objectives of the Ministry of Finance was to simplify the tax structure wherever possible. In line with this objective and to alleviate the burden of costs on companies, I have decided to suspend, with effect from 1 April 1985, the collection of:
>
> (i) payroll tax and,
> (ii) tax on telephone services and on trunk-call services to West Malaysia.

(b) Ten percent concessionary tax rate for Asian Currency Unit (ACU) income

> When the 10% concessionary tax rate for ACUs[1] was introduced in 1972, it was limited to income from the booking of offshore loans in Singapore. With the growth of financial services, the concession was similarly extended to cover new instruments and activities.
>
> Banking services have diversified from more traditional areas into fee-based services. I am therefore extending the 10% concessionary tax on ACU offshore income to cover the following categories of income with effect from Year of Assessment 1986:
>
> (a) income earned by ACUs from providing offshore guarantees, performance bonds and standby letters of credit,
> (b) commissions and other income such as custodian and nominee fees, handling and registration charges earned in respect of transactions on behalf of non-

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[1] Editor's note: Some 159 banks in Singapore, including merchant banks, are licensed to operate ACUs, i.e. separate accounting units within a financial institution that are authorised to conduct foreign exchange transactions and operations in the Asia dollar market.

residents (excluding permanent establishments in Singapore) in foreign stocks and shares and other securities denominated in foreign currency and issued by foreign companies defined for the purpose of this concession to be companies which are not incorporated in Singapore or Malaysia,

(c) commissions and other income earned in respect of offshore remittances, and

(d) income earned in respect of offshore transactions involving interest rate and currency swaps.

(c) Stamp duty

Stamp duty on offshore loan agreements was abolished in 1980. The exemption covered stamp duty payable in respect of assignments of an interest in such offshore loan agreements, provided that the assignor was an ACU in Singapore. Thus, an assignment made by a person outside Singapore to an ACU in Singapore, for example, would not enjoy the stamp duty exemption. In order to further promote the growth of the Asian Dollar market and encourage banks to use Singapore as their regional loans management centre, I am removing the restriction that the assignor must be an ACU in Singapore, with immediate effect.

In view of the rapid changes in financial services offered by banks and the introduction of innovative financial facilities, there is a need to extend the stamp duty exemptions. I am therefore exempting with immediate effect not only offshore loan documents from stamp duty but also documents involving other offshore credit facilities such as underwriting facilities, letters of credit (including standby letters of credit), guarantees and performance bonds.

(d) Entertainments duty

To encourage the tourist industry in Singapore I have decided that with effect from 1 April 1985, duties on entertainments, with the exception of racing of animals, vehicles, motor vessels or aircraft, will be reduced to 10%.

I also propose to remove the existing legislative control on cinema admission prices so that prices will be dictated by market forces. This is in line with our policy of less government regulation of private enterprises. It will also remove the existing anomaly whereby cinemas are the only form of entertainment which is subject to price control.

(e) Income from professional services rendered overseas

To encourage our firms and professionals to be more aggressive in exporting their expertise and services I intend to give more favourable treatment than at present to income repatriated from certain countries.

Currently, all income earned abroad and remitted back to Singapore is subject to Singapore tax. Where there is an Agreement for the Avoidance of Double Taxation (DTA) with the country of income source, Singapore will give a tax credit for taxes suffered overseas. This tax credit will be offset against the Singapore tax payable on the "grossed-up" foreign source income.

However, there is no tax credit if income is remitted from a non-DTA country. In such cases, Singapore will tax the net income which has been remitted. Therefore, income which has been remitted from a non-DTA country suffers additional tax in Singapore.

I now propose to extend a unilateral tax credit to service income remitted from certain non-DTA countries. With such a tax credit, where the income is remitted from a country with a rate of tax equal to or higher than Singapore's, no additional tax will be paid in Singapore if taxes have been paid overseas.

Where, however, the income is remitted from a country with a lower rate of tax, it will be subject to Singapore tax, but credit will be given for overseas taxes paid. Even if some Singapore tax is payable, it will be less than what is due under the present system.

This concession which will take effect from Year of Assessment 1986 will cover income from professional services such as accounting, legal, medical, engineering, architectural, compuer-related, technical and other consultancy services rendered by firms and individuals.

(f) Tax changes for individuals

In last year's Budget Statement, I announced substantial reductions in personal income tax rates and estate duty. With these reductions I am satisfied that the taxation of personal income and capital in Singapore today is equitable and not unduly onerous. I therefore do not propose to make any major tax changes for individuals this year. However, I would like to assure Honourable Members that the Government will review on a continuing basis the level and distribution of the tax burden. We will make adjustments when necessary to correct for inflation and to ensure that initiative and enterprise are not blunted by too high levels of income taxation.

(g) Tax deductibility of certain educational expenses for individuals

There is one area of personal initiative which, in my view, deserves encouragement. Individuals who take the time, effort and expense to improve their skills and knowledge should be rewarded. In particular, those individuals who are in employment and take up part-time or correspondence courses, or those who give up their jobs temporarily to further their education should be helped. I have therefore decided to allow tax deductibility of expenses incurred by individuals in pursuit of further academic and professional qualifications, or vocational qualifications related to their business, trade or employment.

Tax deduction will be allowed for compulsory course fees, including examination fees, and will be subject to a maximum of $2,000 with effect from Year of Assessment 1986. No claims for textbooks, travelling or living expenses will be entertained.

(3) Tax increases

The Minister finally dealt with tax increases. Extracts of his speech on tax increases are reproduced below:

(a) Road taxes on motor vehicles

In my Budget Statement last year, I mentioned the need to restrain the growth of the motor car population in Singapore in order to contain the problem of congestion on our roads.

As a result of the substantial increases in registration fees and road taxes on cars, petrol duty and car park charges since October 1983, the growth of the motor car population was reduced from 12.1% in 1983 to 7.3% in 1984. However, this lower rate of increase is still much higher than the projected increase of about 3% per annum in the road network over the next 3–5 years.

In view of this, I have decided that with effect from tomorrow, road taxes on motor cars and goods cum passenger vehicles will be increased by 15%.

(b) Duty on petrol

I have also decided to raise the ad valorem duty on petrol from 50% to 60% with effect from today. This is one of the most equitable ways of discouraging excessive usage of motor vehicles and is in line with government's energy conservation policy.

(c) Diesel tax on taxis

The diesel tax of 6 times the annual road tax has been levied on diesel-powered private motor cars since 1971. However, no diesel tax is imposed on diesel-powered taxis. Over the years, customs duty on petrol has been increased to restrain the growth of the motor car population. There was no similar increase in duty on diesel. This has resulted in a severe disparity in fuel cost between petrol and diesel operated vehicles.

As diesel-powered taxis do not pay diesel tax, the fuel cost of taxis is unrealistically low compared to that of petrol-powered private motor cars. This is undesirable because taxis take up as much road space as other motor cars.

Therefore, with effect from 1 October 1985, I propose to extend the diesel tax of 6 times annual road tax presently applicable only to private motor cars, to all diesel-powered taxis.

IV. CONCLUSION

In concluding his Budget speech, the Minister said,

> In contrast to last year's budget, when I gave large concessions in personal income tax rates and estate duty to individual taxpayers, the focus of this year's budget is on the corporate sector. This change of emphasis is deliberate. I expect 1985 to be a testing year as companies adjust their operations and trim their manpower to cope with a less buoyant economic environment. Some sectors may do less well than others. But we have the necessary reserves to ride through this bumpy period and Government will ensure that our economic policies are sufficiently flexible so that no sector gets into major difficulties.
>
> But while coping with present difficulties we should not let ourselves be deflected from our long term objectives. In 1980 the Ministry of Trade and Industry put forward an economic development plan for the 1980s with the following broad economic targets:
>
> (a) Real GDP growth of 8-10% per annum to reach the 1980 Japanese per capita GNP by 1990.
> (b) Productivity increase of 6-8% per annum.
> (c) Full, better paid and higher skilled employment.
> (d) Inflation lower than the world average.
> (e) Healthy balance of payments.
>
> We are well on track towards meeting these targets. We should now consider how to fine-tune our economic strategy to make sure that we will continue to make rapid progress in the second half of this decade.
>
> With the experience of the first five years behind us it is timely to set up a high level committee, comprising representatives from the Government, private sector and trade unions, to undertake an in-depth mid-term review of our economic development plan for the 1980s. The Committee will be chaired by the Minister of State (Defence and Trade and Industry) BG Lee Hsien Loong. It will hold discussions with and invite representations from employer and professional associations, chambers of commerce, industry groups, bankers and trade unions in order to come up with specific recommendations as to how government economic policy should be structured for the rest of this decade. In its deliberations the Committee will pay particular attention to the problems of our local industries and propose measures to foster greater entrepreneurship in our business community.
>
> In twenty-five years of government under the People's Action Party (PAP) we have built a strong resilient economic base which is capable of taking hard knocks and which will not buckle when the going gets rough. We cannot expect that each year will automatically be better than the last. There will be occasional storms. But Singaporeans are a robust people with a robust attitude to life and its vicissitudes. With co-operation between the government, employers and workers, we have overcome problems which many observers would have regarded as insurmountable. Provided that we continue the same co-operation we shall overcome whatever problems that may confront us in the future.

APPENDIX I

ENTERTAINMENTS DUTIES

Category	*Existing duty*	*New duty*
Cinemas		
(i) Closed cinema	35%	10%
(ii) Drive in	35%	
(iii) Open air	15%	
Amusement parks		
Wonderland, Gay World, Mandai Orchid Garden, World Insectarium, Crocodile Farm, etc.	35%	10%
Sports		
(i) Racing of animals, vehicles, motor vessels or aircraft	35%	no change
(ii) Professional boxing or wrestling	15%	10%
(iii) Other games or sports	10%	no change
Miscellaneous shows		
(i) Live entertainment	25%	10%
(ii) Exhibitions and trade fairs	35%	10%

APPENDIX II

ROAD TAXES

a) Road tax for private passenger motor cars:

Engine capacity	*Current road tax (cents/cc)*	*New road tax rate (cents/cc)*
1000 cc and below	52	60
1001 – 1600 cc	65	75
1601 – 2000 cc	78	90
2001 – 3000 cc	91	105
Above 3000 cc	130	150

b) Road tax for company registered motor cars will be double the above rates for private motor cars.

c) Road tax for goods-cum-passenger vehicles:

Engine capacity	*Current road tax (cents/cc)*	*New road tax rate (cents/cc)*
1000 cc and below	40	46
1001 – 1600 cc	50	58
1601 – 2000 cc	60	69
2001 – 3000 cc	70	81
Above 3000 cc	100	115

In addition, the following current tax based on the unladen weight is payable:

Unladen weight	*Tax payable*
Up to 500 kg	$ 36 pa
501 – 1000 kg	$ 72 pa
1001 – 1500 kg	$ 108 pa
1501 – 2000 kg	$ 144 pa
2001 – 2500 kg	$ 180 pa
2501 – 3000 kg	$ 216 pa
3001 – 3500 kg	$ 252 pa

APPENDIX III

TAXI FARES

Taxi fare	*Current fare*	*New fare*
Flag down	$ 1.20 for first 1.5 km	$ 2.00 for first 2.0 km
Subsequent distance	10 ¢ per 375 m	10 ¢ per 275 m up to 10 km; 20 ¢ per 275 m after 10 km
Waiting time	10 ¢ per min	10 ¢ per 45 sec
Additional passenger surcharge	10 ¢ for each adult passenger in excess of 2 adult passengers (3 children under 12 years old = 2 adult passengers)	50 ¢ for each adult passenger in excess of 2 adult passengers (3 children under 12 years old = 2 adult passengers)
Midnight surcharge	50% of metered fare betw 1 am and 6 am	50% of metered fare betw 12 midnight and 6.00 am
Luggage surcharge	10 ¢ per piece of luggage	$ 1 for all luggages placed in the boot

There is no change to the other existing surcharges.

SUMMARY OF TAX CHANGES AND TAX INCREASES

For ease of reference, tax changes and tax increases as announced in the 1985 Budget Statement are summarised below:

I. TAX CHANGES

a. Payroll tax and tax on telecoms telephone bills

The collection of payroll tax and tax on telephone services and on trunk-call services to West Malaysia had been suspended with effect from 1 April 1985.

b. Ten percent concessionary tax rate for Asian Currency Unit (ACU) income

With effect from Y/A 1986, the 10% concessionary tax rate for ACUs will be extended to income derived from the following activities:

i. income earned by ACUs from providing offshore guarantees, performance bonds and standby letters of credit,

ii. commissions and other income such as custodian and nominee fees, handling and registration charges earned in respect of transactions on behalf of non-residents (excluding permanent establishments in Singapore) in foreign stocks and shares and other securities denominated in foreign currency and issued by companies which are not incorporated in Singapore or Malaysia,

iii. commissions and other income earned in respect of offshore remittances, and

iv. income earned in respect of offshore transactions involving interest rate and currency swaps.

c. Stamp duty

With effect from 8 March 1985, stamp duty would not be payable in respect of assignment of interest in offshore loan agreements, irrespective of whether the assignor was an ACU in Singapore.

Documents involving other offshore credit facilities such as underwriting facilities, letters of credit (including standby letters of credit), guarantees and performance bonds would also be exempt from stamp duty.

d. Entertainments duty

With effect from 1 April 1985, duties on entertainments, with the exception of racing of animals, vehicles, motor vessels or aircraft, had been reduced to 10%.

Existing legislative control on cinema admission prices had also been removed.

e. Income from professional services rendered overseas

With effect from Y/A 1986, remittance of income from non-DTA countries in respect of professional services such as accounting, legal, medical, engineering, architectural, computer-related, technical and other consultancy services rendered by firms and individuals will qualify for unilateral tax credit.

f. Tax deductibility of certain educational expenses for individuals

Tax deduction will be allowed for compulsory course fees, including examination fees, and will be subjet to a maximum of $ 2,000 with effect from Year of Assessment 1986.

II. TAX INCREASES

a. Road taxes on motor vehicles

With effect from 9 March 1985, road taxes on motor cars and goods cum passenger vehicles had been increased by 15%.

b. Duty on petrol

With effect from 8 March 1984, the ad valorem duty on petrol had been raised to 60%.

c. Diesel tax on taxis

With effect from 1 October 1985, the diesel tax of 6 times annual road tax will be extended to all diesel-powered taxis.

REPUBLIC OF SOUTH AFRICA:

The 1985 Income Tax Changes

By Dr. Erwin Spiro LL.D(h.c.)

On 18 March 1985, the new Minister of Finance, Mr. Barend Du Plessis, presented the first budget to a joint session of Parliament, including the House of Representatives and the House of Delegates. He pointed out that the appointment of the *Margo Commission* was the Government's acknowledgment that the present taxation system needed in-depth revision and was confirmation of its own publicly expressed reservations on the matter. But in the present economic climate it was, unfortunately, not possible to refrain from making any basic changes until the *Margo Commission,* as well as another commission, had submitted their reports, and, although major basic changes could be avoided, certain interim tax adjustments had to be made and are now set out.

I. INCOME TAX ON COMPANIES

In the case of non-mining companies the rate remains unchanged at 50%.

However, mining companies must make a special contribution by means of a surcharge on their tax: a special temporary additional surcharge of 5% over and above the present 20% surcharge on all gold and diamond companies and a special surcharge of 15% on all other mining companies which will raise their normal tax rate to 57.5%, commensurate with the new average rate for the gold mines.

II. LEVY ON PRODUCERS OF SYNTHETIC FUELS

A special temporary levy is to be imposed on producers of synthetic fuels, details to be negotiated with the companies concerned.

III. LONG-TERM INSURERS

In the light of fiscal requirements and with a view to spreading the burden as widely as possible, the Minister proposed a special levy on life insurance business for years of assessment ending during the period 1 April 1985 to 31 March 1986 amounting to an effective 7.5% tax on gross income.

IV. BANKS

For the same reasons there will be a special levy on all registered banking institutions under the Banks Act at the rate of 0.25% of the average amount of all deposits held in the Republic by each institution at the end of each quarter during the calendar year 1984.

V. INDIVIDUAL INCOME TAX

To alleviate certain losses of revenue due to the raising of the thresholds for the maximum marginal rates and longer phasing-in periods for car benefits and soft loans, an increase in the surcharge on tax payable from the originally envisaged 5% to 7% for individuals regardless of age is proposed. This surcharge will, however, be payable on the amount by which a person's net tax, as calculated according to the new tables, exceeds R 750.

VI. TAX CONCESSIONS TO INDIVIDUALS

Unmarried taxpayers

The maximum rate to tax will now apply to unmarried taxpayers only at R 42,000, exceeding earlier promises (but the earlier promised maximum rate of R 60,000 in the case of married persons was not exceeded).

Thresholds

The thresholds at which tax liability commences will be raised in the case of a married person from R 4,384 to R 5,988 and in the case of an unmarried person from R 3,576 to R 4,232. This will be done by increasing the basic rates of tax and at the same time increasing the primary rebate from R 460 to R 880 for a married person and from R 380 to R 620 for an unmarried person.

Senior citizens

The Minister believes that the elderly people, many of whom found themselves in "difficulties as a result of the ravages of inflation on retirement incomes", ought to be assisted to retain their financial independence for as long as possible. The present tax rebate of R 300 for those over 70 years and R 120 for those over 65 and under 70 years of age will, therefore, be replaced by a uniform R 500 rebate; the rebate for the 60-64 age group remaining at R 120. In the case of a married person aged 65 or over this increased rebate is to raise the threshold at which he becomes liable for income tax from R 5,384 to R 9,113; for an unmarried person in this group the threshold is raised from R 4,576 to R 7,357.

Medical expenses

In regard to medical expenses the deductions allowed for the 1986 tax year will be increased as follows: married persons under 60 from R 1,000 to R 1,500; unmarried persons under 60 from R 750 to R 1,000; married persons over 60 and under 70 from R 3,000 to R 4,000; unmarried persons over 60 and under 70 from R 2250 to R 3000. There remains no ceiling to the medical expenses of persons over the age of 70 years.

Incentive to save

With effect from the 1986 tax year an additional incentive to save will be granted by way of an increase in the exemption limit from R 100 to R 250. The exemption will now apply only to interest earned, but not to dividends.

Initial allowances

The initial allowance granted in respect of new or unused machinery or plant used in a manufacturing process will be increased from 25% to 50% instead of the originally indicated 55%. The enhanced allowance will be limited to new or unused machinery or plants brought into use by 31 December 1986. The initial allowance for buildings will be calculated at the rate of 17.5% of the relevant cost and the allowance will be limited to a building the construction of which commenced not later than 31 December 1987.

VII. TAX AVOIDANCE

The Commissioner for Inland Revenue who has a measure of discretion when dealing with various degrees of "transgression" (what is apparently meant is tax avoidance) has, as the Minister pointed out, agreed to treat with leniency those who are willing to come forward during the next three months, i.e. until the end of June 1985, to rectify matters and also those who, through ignorance, have not fully shouldered their tax responsibilities.

More particularly, dubious schemes for avoiding taxation on fringe benefits continue, according to the Minister, to be reported, some of such schemes involving the granting of housing benefits channelled indirectly through pension funds, insurance companies and other parties. The Minister threatened (if need be) to introduce legislation to counter these schemes and with retrospective effect, warning employers and their advisers who indulged in such practices to take note and be aware that they were now at risk.

VIII. RATES OF (NORMAL) INCOME TAX

Persons other than companies

Persons other than companies, in respect of taxable income derived from sources within or deemed to be within the Republic for the year of assessment ending on 28 February 1986 or 30 June 1986 (as applicable) are subject to (normal) income tax calculated in accordance with Tables I and II. However, there is to be added to the tax so calculated a surcharge equal to 7% of the net amount (such amount arrived at by deducting the rebates provided for in section 6 of the Income Tax Act, 1962, from the tax so calculated) as exceeds R 750.

TABLE I

Taxable income	*Rates of tax in respect of married persons*
Where the taxable income –	
does not exceed R 12,000	16%
exceeds R 12,000 but does not exceed R 13,000	R 1,920 plus 18% of the excess over R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 2,100 plus 20% of the excess over R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,300 plus 22% of the excess over R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,520 plus 24% of the excess over R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,760 plus 26% of the excess over R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 3,280 plus 28% of the excess over R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 3,840 plus 30% of the excess over R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 4,440 plus 32% of the excess over R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 5,080 plus 34% of the excess over R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 5,760 plus 36% of the excess over R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 6,480 plus 38% of the excess over R 28,000;
exceeds R 30,000 but does not exceed R 32,000	R 7,240 plus 40% of the excess over R 30,000;
exceeds R 32,000 but does not exceed R 34,000	R 8,040 plus 42% of the excess over R 32,000;
exceeds R 34,000 but does not exceed R 36,000	R 8,880 plus 43% of the excess over R 34,000;
exceeds R 36,000 but does not exceed R 38,000	R 9,740 plus 44% of the excess over R 36,000;
exceeds R 38,000 but does not exceed R 40,000	R 10,620 plus 45% of the excess over R 38,000;
exceeds R 40,000 but does not exceed R 50,000	R 11,520 plus 46% of the excess over R 40,000;
exceeds R 50,000 but does not exceed R 60,000	R 16,120 plus 48% of the excess over R 50,000;
exceeds R 60,000	R 20,920 plus 50% of the excess over R 60,000.

TABLE II

Table income	*Rates of tax in respect of persons who are not married persons*
Where the taxable income –	
does not exceed R 10,000	16% of each R 1 of the taxable income;
exceeds R 10,000 but does not exceed R 11,000	R 1,600 plus 18% of the excess over R 10,000;
exceeds R 11,000 but does not exceed R 12,000	R 1,780 plus 20% of the excess over R 11,000;
exceeds R 12,000 but does not exceed R 13,000	R 1,980 plus 22% of the excess over R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 2,200 plus 24% of the excess over R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,440 plus 26% of the excess over R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,700 plus 28% of the excess over R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,980 plus 30% of the excess over R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 3,580 plus 32% of the excess over R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 4,220 plus 34% of the excess over R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 4,900 plus 36% of the excess over R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 5,620 plus 38% of the excess over R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 6,380 plus 40% of the excess over R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 7,180 plus 42% of the excess over R 28,000;
exceeds R 30,000 but does not exceed R 32,000	R 8,020 plus 44% of the excess over R 30,000;
exceeds R 32,000 but does not exceed R 34,000	R 8,900 plus 45% of the excess over R 32,000;
exceeds R 34,000 but does not exceed R 36,000	R 9,800 plus 46% of the excess over R 34,000.

Companies

Companies, in respect of taxable income derived from sources within or deemed to be within the Republic for every year of assessment up until 31 March 1986 are subject to the following rates of (normal) income tax:

(i) on each rand of the taxable income (excluding taxable income derived from mining operations and taxable income referred to in (ii)(c) below), 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 in the law plus a surcharge equal to 25% of such 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 equal to 25% of such amount;
  (c) for excess recoupments over capital expenditure accruing to companies, the average rate of tax as determined in accordance with the Act or 35 cents per rand, whichever is higher, such average rate to be determined as laid down;

(iii) in respect of taxable income derived from diamond mining, 45 cents per rand of taxable income plus a surcharge equal to 25% of such amount;

(iv) in the case of mining companies, other than gold or diamond mining companies, 50 cents on each rand of the taxable income so derived plus a surcharge equal to 15% of such amount.

Saving clause

The taxes determined in accordance with the above are cumulative, one tax not excluding any other.

IX. 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 in the law.

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 a tax at progressive block rates, the block exceeding R 90,000 being taxable at the rate of 25%.

REPUBLIC OF SOUTH AFRICA:

Budget 1985-86

On 18 March 1985 Mr. Barend Du Plessis, Minister of Finance, pronounced his budget speech, extracts of which are published in this issue.

. . .

THE TAX STRUCTURE OF SOUTH AFRICA

Tax reform

Tax reform has of late received increasing attention world wide in a variety of ways. The trend seems to be one of the reduction of taxes in order to create and expand wealth. This is in sharp contrast to the more "orthodox" approach of increasing taxes to redistribute wealth.

The Margo Commission

Our own tax structure has recently been severely criticized in various quarters. The appointment of the Margo Commission is the Government's own acknowledgment that the present system needs in-depth revision and confirmation of its own publicly expressed reservations on the matter. I expect the Commission to be innovative in its investigation and, if need be, to propose far-reaching changes in order to enable the new structure to meet the many and varied demands our economy will place on it.

In these circumstances the ideal approach would probably have been to refrain from making any basic changes until the Commission had submitted its report. In the present economic climate this is unfortunately not possible, and although major basic changes could be avoided, certain interim tax adjustments, which I shall presently discuss, have been unavoidable. These changes are of necessity *ad hoc* in nature, but the Commission will be requested to evaluate them as part of its inquiry.

While on this subject I should also like to draw the attention of honourable members to a few matters that have not yet been finalized or conclusively studied by the Margo Commission,, but on which some comment at this time seems appropriate.

Indirect taxes

The first concerns the thorough investigation into indirect taxes conducted recently by a technical assistance mission of the International Monetary Fund at the request of the Department of Finance. I expect a written report from the Fund before the middle of this year, but discussions with this mission indicated that the report will be of great assistance to both my Department and the Margo Commission.

Working couples

I had hoped to have been able to address this problem of the taxation of working couples in the 1985 budget after the Margo Commission had had an opportunity of framing recommendations in this regard. However, the Commission advised me that it is unfortunately not in a position to make any recommendation on the taxation of married couples at this early stage of its work, and much as I should like to deal with this longstanding issue now, it would clearly be inappropriate either to confirm or change the system before the recommendations of the Commission were to hand.

Estate duty

Once again, because of the short time since it has been constituted and the urgent attention it had to devote to fringe benefits taxation, the Margo Commission has not found it possible to discuss and formulate recommendations on estate duty and all related issues. It has however been informed that in the Government's opinion estate duty, at least in its present form, can no longer be regarded as appropriate to the needs of our time. As an interim measure, certain amendments will be introduced during this session of Parliament in consequence of the Matrimonial Property Act, 1984.

Insurance policies

The growth in the number and value of insurance policies with no risk cover is causing concern. These policies, usually referred to as "pure endowment" policies, are simply investments with no life cover, but by reason inter alia of the provisions of the Income Tax Act relating to the taxation of insurance business, the rate of return on such policies is appreciably higher than that offered on many other investments.

This problem of lack of tax neutrality was referred to the Van der Walt Committee appointed to inquire into matters relating to long-term insurance. Unfortunately that Committee has not yet been able to submit a report on this matter. Because of the appointment of the Margo Commission with wider terms of reference, this issue should now also be dealt with by the latter body. As soon as its report is received this problem will be given urgent attention.

Fringe benefits

It has come to my attention that dubious schemes for avoiding taxation on fringe benefits continue to be devised. Some of these schemes involve the granting of housing benefits channeled indirectly through pension funds, insurance companies and other parties.

I must reiterate what I said earlier during the present session of Parliament: I shall not hesitate to introduce legislation to counter such schemes, and with retrospective effect. Employers and their advisers who indulge in such practices would be well advised to take note and accept that they are now at risk.

Tax collections

In spite of difficulties caused by a shortage of trained staff and inadequate accommodation, Inland Revenue has succeeded in increasing its tax collection efficiency by dint of a special effort during the latter part of last year. The results are reflected in the growth in revenue figures. I thank the officials for their efforts.

It is self-evident that Inland Revenue must take enforcement measures and deal strictly with defaulters. One would, however, have preferred taxpayers to meet their obligations voluntarily.

It is regrettably true that there are those who consciously and wilfully evade taxation and those who cynically manipulate tax avoidance to such an extent that it cannot be construed as anything but evasion of taxation. I have requested the Margo Commission to look into all possibilities of increasing our capability to collect as completely as possible from taxpayers that which they rightfully should pay to the fiscus and to advise me on making penalties substantially heavier where appropriate.

The Commissioner for Inland Revenue, however, is by law clothed with a measure of discretion when dealing with various degrees of transgression. He has agreed to treat with leniency those who are willing to come forward during the next three months, that is until the end of June 1985, to rectify matters and also those who through ignorance have not fully shouldered their tax responsibilities. As from 1 July, the Commissioner will deal severely with those who are cadging a tax lift on the backs of their fellow South Africans.

I trust that those concerned will make use of this period of grace.

I hope to receive the Margo Commission's recommendations on all the issues mentioned and many others in the course of the next twelve months or so. The work already done by the Commissioners, their enthusiasm, thoroughness, experience and balance are noted as sincerely appreciated by all and I have no doubt that the work and effort being put into its mammoth task cannot but redound to the benefit of all.

. . .

FINANCING PROPOSALS

After taking into account the supplementary expenditure proposals amounting to R 164 million, expenditure for 1985-'86 will amount to R 30,892 million, which is 13.6% above that for 1984-'85. If the structural adjustment mentioned earlier involving a net amount of R 599 million is excluded from this total – as it should be for purposes of comparison – then the *increase in total expenditure is 11.4%,* well below the current inflation rate.

Although total expenditure is much reduced in real terms, revenues on the existing tax base amounting to R 26,585 million will still be insufficient to finance the budgeted expenditures. On this basis the deficit before borrowing will be as much as R 4,307 million or some 3.7% of the expected gross domestic product.

It is imperative that this Budget should contribute towards economic recovery, lower inflation and meeting the requirements of sound financing cited before, notably, that current expenditure be not financed by loans. Any deficit of this magnitude will not meet the criteria and will in fact exacerbate our present unbalanced "mix" of fiscal and monetary policy measures. The deficit substantially exceeds the total of our capital expenditure and must be brought down to more manageable proportions by first raising additional revenue before the remainder can be borrowed.

ADDITIONAL TAXES

There is then unfortunately no alternative but to seek additional revenue by proposing further taxes. In doing so we are fully aware of the disadvantages of increasing taxes when the economy is in a downward phase. However, having done everything in our power to cut expenditure to the bare minimum, our next best option is to finance such expenditure in a sound and responsible manner.

This approach will contribute towards getting our economy in shape again and will advance materially the date when sound economic growth can be resumed. It is impossible to over-emphasize the truism that taxation should not be seen as a punitive measure, but to finance the functions and services that benefit the community at large.

After dealing with the additional tax proposals though, good news will follow in the form of various proposals for relief, particularly for senior citizens.

We look at customs and excise first.

Customs and excise

Ad valorem duty on imported cars

Motor cars imported in a built-up condition at present attract customs duty of 100%. There has been a substantial increase in imports of such cars in recent times, due mainly to the relaxation of import control but no doubt also aided by the favourable treatment of fringe benefits. As these cars fall very largely into the luxury class, I propose that the customs duty be increased to 125%. This could also help the sales of locally produced cars.

The additional revenue for 1985-'86 from this source is estimated at R 10 million.

Video cassette recorders

Although relatively modest at first, sales of these recorders have risen very sharply in recent years and contributed to a further drain on the already stretched current account of our balance of payments without making a significant contribution to our revenues. In these circumstances I propose, for fiscal purposes, that the ordinary customs duty of 10% be increased to 15%, in addition to the *ad valorem* excise duty of 35% applicable now.

This should yield some R 5 million in 1985-'86.

Ad valorem customs an excise duties on office machines and certain electronic devices

I wish to propose next an *ad valorem* excise duty and an *ad valorem* customs duty of 10% on office machines and certain electronic devices as defined in my taxation proposals.

The revenue for 1985-'86 is estimated at R 100 million.

Petrol

Petrol derived from imported crude oil is subject to an excise duty of 10.25 cents per litre, whereas for petrol derived from coal the duty is only 9.337 cents. The difference of 0.913 cents has served to protect locally produced synthetic fuel; but in view of the recent sharp increase in the landed cost of imported fuel. It is now evident that these producers no longer need this protection and that the duty on petrol from coal can be at least equalized with that of other petrol. I proposed then that the excise duty on such petrol be increased to 10.25 cents per litre.

This will yield some R 26 million for 1985-'86 *without raising the pump price of such fuel.*

Implementation

All 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.

Mr Speaker, in terms of Section 58(1) of the Customs and Excise Act, No. 91 of 1964, I now table for consideration by Parliament the formal taxation proposals on customs and excise duties.

Since all the increased duties are levied at the point of import or manufacture, there is no justification whatsoever for merchants to increase the prices of stocks inventoried to them at the old rates of duty. In the present economic climate I therefore rely on such merchants to adjust their prices only on new stocks. Consumers should expect and insist that the retail prices of all goods concerned should not be raised by more than the increase in duty.

The high customs and excise duties proposed should yield R 141 million in 1985-'86.

Inland revenue

Individual income tax

In my 6 December 1984 announcement on fringe benefit taxation I pointed out that the raising of the thresholds for the maximum marginal rate would result in a loss of revenue, which would be only partly compensated for by imposing an overall surcharge of 5% on assessed tax.

I emphasized, however, that this surcharge would depend on the Exchequer's position in the new year as well as on the interim recommendations to be made by the Margo Commission in this regard.

The Margo Commission has indeed since then proposed a longer phasing-in period for car benefits and soft loans, recommendations which were accepted by the Government. The further loss of revenue from these concessions as well as general revenue requirements necessitate an increase in the surcharge on tax payable from 5% to 7% for individuals regardless of age. I propose however, that this surcharge be payable only on the amount by which a person's net tax, as calculated according to new tables, exceeds R 750.

The additional revenue resulting from this extra 2% surcharge is estimated at R 120 million for 1985-'86 and R 135 million in a full year.

General sales tax

Any taxation system should reflect a reasonable balance between direct and indirect taxation. I have proposed certain increases in direct taxation; sales tax is a recognized form of indirect taxation, and to meet our fiscal requirements we shall have to turn to this source as well.

I thus propose that the rate of general sales tax be increased to 12%. We have no option but to allow the business community a reasonable period within which to prepare for this change, and the increase will therefore take effect from Monday 25 March 1985. I must mention that the numerous requests for *further* exemptions of particular food items have all been reviewed in depth, but that it has regrettably not been possible to extend the list of existing exemptions.

This proposal should yield an additional R 1,220 million for 1985-'86.

Income tax on companies

In the case of non-mining companies I propose that the rate remain unchanged at 50%.

As to mining companies, their taxable income is determined according to special rules in terms of which capital expenditure is deductible in full in the year of assessment in which it is incurred, resulting in a deferment of tax on current profits. Since the bulk of the economy and the people of South Africa have had to tighten their belts, it seems appropriate to call upon these companies to make a special contribution to our tax revenues by means of a surcharge on their tax.

I accordingly propose a special temporary additional surcharge of 5%, over and above the present 20% surcharge, on all gold and diamond mining companies. The yield expected for 1985-'86 from this source is R 91 million.

I also propose a special surcharge of 15% on all other mining companies which will raise their normal tax rate to 57.5%, commensurate with the new average rate for the gold mines. Some R 33 million is expected from this source in 1985-'86.

Levy on producers of synthetic fuels

It is Government practice to determine local fuel prices. In its price determination the Government takes into account the rand-dollar exchange rate, since imported fuel is quoted in dollars. The latest sharp increase in domestic fuel prices pegged them at levels that are placing local synthetic oil-from-coal producers in a particularly favourable position. I therefore feel it would be only reasonable to call on these companies also to make a contribution to the fiscus in this difficult year ahead.

I thus propose that a special temporary levy be imposed on these companies, details of which will be negotiated with the companies concerned and embodied in a formal taxation proposal to be tabled later.

This levy should yield R 70 million in 1985-'86.

Long-term insurers

In the absence of any final recommendations by the Van der Walt Committee on the basis of taxation of assurers, a matter which now also falls to be dealt with by the Margo Commission, I should naturally prefer not to suggest any alteration to the tax basis as such. But in the light of our fiscal requirements for the coming year, and with a view to spreading the burden as widely as possible, I propose a special on life assurance business for years of assessment ending during the period 1 April 1985 to 31 March 1986. This levy will amount to an effective 7.5% tax on gross income as calculated in terms of section 28(1) of the Income Tax Act, and should yield R 77 million in 1985-'86.

Banks

In considering how the burden of taxation should be spread equitably among the various sectors of the economy one should look for a contribution by each major sector capable of such effort.

For some years the banking sector has enjoyed a considerable measure of immunity from taxation mainly by reason of the provisions relating to financial leases and suspensive sales, although distributions profits have certainly been earned out of which dividends have been declared.

These concessions have undoubtedly contributed to our economic development, but the present situation demands a review of priorities to ensure that fiscal requirements be met. I propose thus a special levy on all banking institutions registered in terms of the Banks Act, at the rate of one quarter of 1% of the average amount of all deposits held in the Republic by each institution at the end of each quarter during the calendar year 1984.

This levy, which should not exert upward pressure on interest rates, will be payable in instalments and is expected to yield R 100 million in 1985-'86.

Total additional taxation

The additional taxation proposals involve R 141 million for Customs and Excise and R 1,711 million for Inland Revenue.

Tax concessions

I am thankful to be able to announce certain tax concessions to alleviate undue hardship and correct inequities.

Ad valorem duty on motor cars

Notwithstanding the present tight fiscal position I feel that a correction is warranted in the case of the differentiated *ad valorem* duty imposed last year in the absence of agreement on a fringe benefits tax and which entailed an *ad valorem* excise and customs duty of 1% on motor cars with a neutral value not exceeding R 11,500 (which corresponds with a retail value of approximately R 15,000) and of 2% on those with a neutral value exceeding R 11,500.

The fact that fringe benefits are taxed with effect from 1 March 1985 removes the necessity for a differential rate, and it was thus decided to reduce this duty to 1% all round.

The relevant Government Notice will be published tomorrow. This applies to all cars concerned that by tomorrow have not been entered for home consumption.

The estimated loss in revenue for 1985-'86 will be R 12 million.

Income tax on individuals

(a) Unmarried taxpayers

On 6 December 1984, as a result of the phasing in of fringe benefit taxation, I proposed new rates of tax whereby the threshold for the maximum marginal rate would rise from R 40,000 to R 60,000 for a married person and from R 28,000 to R 32,000 for an unmarried person, but with a 5% surcharge in each case.

Although most unmarried persons certainly stood to benefit from this step, it was found that in some cases the relief granted to an unmarried person compared unfavourably with that enjoyed by a married person.

The tax proposals being tabled today have thus been framed so as to provide further relief to unmarried persons, insofar as the maximum rate of tax will now apply to them only at R 42,000.

(b) Thresholds

In addition I wish to propose that the thresholds at which tax liability commences be raised as follows:

Married person, by more than 36% from R 4,384 to R 5,988.

Unmarried person, by more than 18% from R 3,576 to R 4,232.

This will be done by increasing the basic rates of tax and at the same time increasing the primary rebate from R 460 to R 880 for a married person and from R 380 to R 620 for an unmarried person.

The loss of revenue resulting from relief to unmarried taxpayers and from raising the tax threshold is estimated at R 49 million for 1985-'86 and R 56 million for a full year.

(c) Senior citizens

Many elderly people find themselves in difficulties as a result of the ravages of inflation on retirement incomes. Unlike younger persons, they are very often not in a position to augment their incomes and I am often asked: "Why must I pay tax in my old age after a lifetime of hard work during which I paid my taxes?"

Of course, during their working life their pension contributions were in fact exempt from tax, and the fundamental yardstick for measuring tax liability must remain current income, be it from pensions or from whatever source. Nevertheless, we do owe it to our senior citizens to assist them to retain their financial independence for as long as possible, and I therefore propose that the present tax rebate of R 300 for those over 70 years and R 120 for those over 65 and under 70 years of age be replaced by a uniform R 500 rebate. The rebate for the 60-64 age group will remain at R 120.

In the case of a married person aged 65 or over the net effect of the general rates adjustment and this increased rebate is to raise the threshold at which he becomes liable for income tax by nearly 70%, from R 5,384 to R 9,113. For an unmarried person in this group the threshold is raised by over 60%, from R 4,576 to R 7,357.

The loss of revenue is estimated at R 20 million for 1985-'86 and R 23 million for a full year.

(d) Medical expenses

Following the substantial increases in medical expenses during the past year I propose that the deductions from income permitted under the Income Tax Act for the 1985 tax year be increased as follows:

Married persons under 60, from R 1,000 to R 1,500; unmarried persons under 60, from R 750 to R 1,000; married persons over 60 and under 70, from R 3,000 to R 4,000; unmarried persons over 60 and under 70, from R 2,250 to R 3,000.

As to those over 70 years of age, there is already no ceiling to their medical deductions.

The loss of revenue for 1985-'86 is estimated at R 1 million and for a full year at R 3 million.

(e) Incentive to save

At present R 100 of income by way of interest and dividends is exempt from tax. The exemption was aimed at avoiding numerous small assessments in the case of those taxpayers falling under the final deduction system; but it could well be extended for another purpose, namely the encouragement of savings, since our personal savings ratios are disappointingly low. Interest rates on modest savings rarely offer an attractive return, and I therefore propose that, with effect from the 1986 tax year, an additional incentive be granted by way of an increase in the exemption limit to R 250. But the exemption will henceforth apply only to interest earned. Although this concession appears small and may be regarded as inadequate by some, its financial impact on the fiscus is rather severe and unfortunately precludes a larger exemption in prevailing circumstances.

The loss of revenue is estimated at R 33 million for 1985-'86 and R 62 million for a full year.

(f) Initial allowances

In accordance with the decision announced two years ago, the initial allowance granted in respect of new or unused machinery or plant used in a process of manufacture will, where such machinery or plant is brought into use on or after 1 July 1985, be increased in consequence of the withdrawal of the investment allowance.

Last year it was indicated that it would be necessary to adjust the quantum of the allowance to ensure that the sacrifice to the fiscus was not unduly increased as a result of increases in the company rate of tax, and I therefore propose that the initial allowance be increased from 25% to 50% instead of the originally indicated 55% in the case of such machinery or plant. For the time being, until the Margo Commission has reported on this, the enhanced allowance will be limited to new or unused machinery or plant brought into use by 31 December 1986.

I also propose that the initial allowance for buildings be calculated at the rate of 17.5% of the relevant cost and that the allowance be limited to a building the erection of which commences not later than 31 December 1986, provided the building is brought into use not later than 31 December 1987.

The total of these income tax concessions amounts to R 103 million for 1985-'86 and to R 147 million for a full year.

Net additional taxation

The total additional taxation for 1985-'86 is R 1,852 million, while the total concessions amount to R 115 million, leaving a net amount of R 1,737 million.

. . .

CONCLUSION

Short-term impact of the Budget

The Budget I have presented today is not "neutral" but designed to play its full part in our present short-term strategy of according priority to reducing inflation and strengthening the balance of payments. As such, it fully meets the basic conditions I specified earlier:

Firstly, the comparable rate of increase of Government expenditure for 1985-1986 has been limited to only 11.4%, that is to below the current rate of inflation. In other words, there will be a decrease *in real terms*.

Secondly, no current expenditure will be financed from loans in the coming year, as the deficit before borrowing – even including the transfer to the Tax Reserve Account – will be some 5.4% below the budgeted capital expenditure.

Thirdly, the deficit before borrowing has been limited to R 2,570 million, which is considerably below the 3% of gross domestic product originally set as our target. In fact, on the basis of the actual taxation and expenditure proposals, it is no more than 2.2%. Even if provision is made for the amount transferred to the Tax Reserve Account to cover possible lower revenge collections or overruns in expenditure, the deficit should prove well within our means without resort to bank credit or putting upward pressure on interest rates. Indeed, as indicated earlier, net new issues of Government stock in the 1985-1986 year should not amount to more than R 716 million – a figure substantially below the R 1,600 million raised this year.

By meeting these various conditions, the Budget should contribute fundamentally towards the declared objectives of curbing spending, improving the balance of payments, strengthening the exchange rate of the rand and the net gold and other foreign reserves, and, most importantly, reversing the rising trend in the rate of inflation. In this manner, it will pave the way for more rapid and sustainable economic growth.

The tax proposals in today's Budget should be viewed in their proper context, namely as constituting part of our short-term fiscal policy designed to deal with the present abnormal economic situation. They stand in contrast to our longer-term financial strategy, which is designed, among other things, to reduce the tax burden in the interest of private sector growth.

To the best of our knowledge, the Government has not previously set out in such detail its longer-term fiscal and monetary principles and strategies aimed at the attainment of its longer-term economic goals. But it has been thought fitting to give this exposition in order to place the influence of the present economic conditions on our Budget in a warranted and proper perspective.

In next issues:

India: The 1985-86 Budgetary measures – by *S. Gunasekaran*

Reciprocal exemption – A regime to treasure – by *Tony Kelly*

The role of tax treaties as an instrument of economic cooperation between "capitalist" and "socialist" countries" by *Helmut Debatin*

Nigeria: Analysis of some tax issues in the Federal Government by *A.C. Ezejelue*

Collaboration agreements – Some issues by *M.B. Rao*

The E.C. Commission on income taxation and equal treatment for men and women

Statement on the OECD Report of 6 July 1982 – by the *Institut der Wirtschaftsprüfer (IDW)*

Thailand: New withholding taxes – by *Montri Hongskrailers*

Guinea: New investment code – by *Servaas van Thiel*

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-52 of the January 1985 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Individual Income Taxation and Social Benefits in Sweden, the United Kingdom and the U.S.A.

A Study of Their Interrelationships and Their Effects on Lower-Income Couples and Single Heads of Household

By Norma Briggs

Norma Briggs has had an extensive career in government service in the United States of America. In the state of Wisconsin, she served as Executive Director of the Governor's Commission on the Status of Women, 1974-1979, and was Director of the Bureau of Community Services in the Department of Industry, Labor and Human Relations, 1972-1974. For the U.S. federal government, she has directed research studies which have examined why few women apprentices were preparing for the skilled trades and what happened to those who did embark on such training, have assessed the impact of a policy of granting paid sick leave to employees who needed time off for childbirth, have looked at differences in the treatment of men and women under the Comprehensive Employment and Training Act, and have examined the career patterns of women in Wisconsin state government services.

Publications of the Wisconsin Commission on Women which she authored or edited include: *One Step at a Time* (1976), *Wisconsin Women and the Law* (2d and 3d eds., 1977 and 1979), *Real Women, Real Lives* (1978), and *The Marriage Partnership* (1979). She has also published *Women and the Skilled Trades* (Columbus, Ohio: 1979), "Apprenticeship" (in: *American Workers in a Full Employment Economy*, Washington: 1977), and *Women in Apprenticeship: Why Not?* (Manpower Research Monograph 33, Washington: 1974).

This paper will review the tax systems of three countries – the United Kingdom, the United States and Sweden – as they affect women, and will analyze the major features of the three systems and evaluate the results from the standpoint of one who supports women's claims to be given rights, opportunities and treatment equal to those given to men. Each section of the paper briefly reviews the history and social conditions that led to the development of the major features of the tax system as they exist today and as they arguably indicate need for modifications of today's tax system. The focus is particularly on the differences in tax burden on women because of marriage, childbearing and child-rearing in the 1970s and 1980s.

Contents

UNITED KINGDOM

Married women

Income tax was first introduced in the United Kingdom in 1799.[1] The aggregation of a couple's income and the attribution of the whole to the husband for tax purposes was a natural reflection of the legal status of married women and the property laws of the period. At that time a woman upon marriage lost control and management of all her real property to her husband, and any chattels or earnings that were hers became her husband's.[2] As Blackstone summarized:

> By marriage, the husband and wife are one person in law; that is, the very being or legal existence of the woman is suspended during the marriage, or at least is incorporated and consolidated.[3]

Tax law therefore adopted the rule that a married woman's income was to be "stated and accounted for by her husband" and that any profits "shall be deemed the profits of the husband."[4]

Twelve years after the enactment of the Married Women's Property Act in 1882, allowing married women to retain management and control of their separate property and earnings, a new tax provision was added. It allowed a wife's earnings to qualify for the same tax reliefs as those of a single person, where the couple's combined income was less than 500 pounds.[5]

Though the percentages of men and women gainfully employed in the U.K. remained almost constant between 1851 and 1951, at 69% and 31% respectively, less than 10% of married women in the nineteenth century remained in paid employment.[6] Employed women were young and single or from the large reservoir of women unmarriageable because of the shortage of men that stemmed from wars and emigration.[7] Most married women were fully occupied with home responsibilities:

> . . . the typical working class mother of the 1890s . . . experiencing . . . ten pregnancies, spent about 15 years in a state of pregnancy and in nursing a child for the first year of its life. She was tied, for this period of time, to the wheel of childbearing . . . the typical working class mother in the industrial towns in 1900 could expect, if she survived to 55, to live not much more than another twelve years by the time she reached the comparative ease, the reproductive grazing field of the middle fifties.[8]

Under these circumstances the continuation of the taxation of husband and wife as a single unit for which the husband took ultimate responsibility, and the introduction in 1918 of a married man's allowance (since by law he had to support his wife) and its increase in 1921 to 1.6 times a single person's allowance,[9] drew little criticism.

But social conditions changed. Life expectancy increased for women by almost 26 years between 1901 and 1971,[10] the childbearing years were shortened, a higher proportion of women were married[11] and at a younger age:[12] so that by 1974 two-thirds of all employed women were married, and by 1979 over 50% of married women were employed outside the home.[13] As the comprehensive Report of the Committee on One-Parent Families (the Finer Report) summarized in 1974, "the representative working woman of today is married, over forty and has a grown-up family."[14]

At the time the Finer Report was presented to Parliament, the Inland Revenue still treated married women as non-entities for tax purposes, with the logical result that it corresponded only with husbands, refused even to reply directly to married women who sent in letters, and mailed any repayment due on taxes overwithheld from married women's paychecks to their husbands. This convention and other practices that were pointed to as having a discriminatory impact on women led to heated and widespread discussion in the late 1970s and some scathing criticism of the government:

> . . . recently articles in the *Sunday Times* and *Woman's Own* resulted in 30,000 and 6,500 people respectively registering their protest against the current tax laws and, of over 2,000 responses to an E.O.C. [Equal Opportunity Commission] discussion paper, only 15 defended the status quo. The responses presented 'a formidable dossier of dissatisfaction' (EOC 1979, p. 4), which is a strong desire for change.[15]

Particularly criticized were the rules for applying the allowances that meant "that equal pay does not yet mean equal take-home pay".[16] These rules meant that a married woman's earned income allowance,[17] at the level of a single person's allowance since 1942, was less than that of a married man; that the wife's earned income allowance was given not to her but to her husband to set against his income; that the mortgage interest deduction was the husband's, not the wife's; and that when a couple's aggregate income moved into a higher tax bracket the increased withholding was taken from the wife's, not the husband's, paycheck.[18]

Such diminutions of the married woman's already much

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[1] *The Taxation of Husband and Wife* 58 (Cmnd 8093 (1980)) [hereinafter Cmnd 8093].

[2] L. Kanowitz, *Women and the Law* 36 (1968).

[3] W. Blackstone, *Commentaries* 433.

[4] Cmnd 8093, at 58.

[5] Id.

[6] 1 Committee on One-Parent Families (The Hon. Sir M. Finer, Chairman) *Report* 23 (Cmnd 5629, 1974) [hereinafter *Finer Report*].

[7] Id.

[8] R. Titmuss, *Essays on the Welfare State* 91 (2d ed., 1963).

[9] Cmnd 8093, at 58.

[10] 1 *Finer Report* 33.

[11] Id. at 26. In 1871, only 34.8% of women aged 20 to 24 had ever married. In 1971, 60.3% had married.

[12] Id. at 28. The percentage of women who married unskilled manual workers before they were 20 years old, for example, rose from 20% in 1947-51 to 41% in 1960-61.

[13] Lister, *Taxation, Women and the Family,* in *Taxation and Social Policy* 138 (C. Sandford, C. Pond & R. Walker ed., 1980) [hereinafter Lister].

[14] 1 *Finer Report* 37.

[15] Lister, at 140.

[16] Lister, at 137.

[17] "A married man living with his wife is also entitled, if she has earned income, to a deduction of the amount of her earnings up to a maximum of £ 595." M. Hepker, *A Modern Approach to Tax Law* 52. Hepker states the law as of July 9, 1973. Subsequent legislation has raised the amount of relief to £ 1565 for 1982-1983, but has not impaired its parity with the single person's allowance. Reference Services, Central Office of Information, *Britain's Tax Changes: 1982 Budget* 1 (No. 151/82, 1982) (Supplement to *A Short Guide to Taxes in Britain,* No. 24/81, 1981).

[18] Cmnd 8093, at 11.

smaller paycheck[19] are sharply felt, in a way that they would not be if it were customary for couples to pool their available resources by having their paychecks automatically deposited in a joint bank account, for instance.

There is a thriving British tradition of privacy in money matters that makes many feel indecently vulnerable if their spouses even know what they have. This is reflected in a government Green Paper's acknowledgement that though the separate assessment option, elected by only 3% of married women in 1979,[20] "secures for the wife the right to handle her affairs independently" (and makes no difference to the tax charged to the couple) its *disadvantage* was that it made it "possible for each spouse to deduce – from his/her own allocation of the tax bill – the approximate size (though not the sources) of the other's income."[21]

Real incomes have dropped in the U.K. over the past decade. The consumer price index set at 100 for 1970 rose to 563 by 1980,[22] an almost six-fold increase, while the hourly manufacturing wages for men went from 0.644 pounds to 2.275 pounds, an increase halfway between three and four times.[23] In this context the problem of whether the husband or wife (where both have resources) should contribute more becomes acute. A government Green Paper reported that wives express distrust that their small "nest-egg" of savings will be consumed if their husband learns of it.[24] Husbands are under greater pressure to increase the household expense allowance to their wives and to be content with a smaller share of what they have traditionally considered to be their *personal* income.[25] All of these factors have converged and given added motion to the women's movement for reform.

The 1978 Finance Act gave wives the right to receive their own PAYE (withholding) repayments. In the same year, tax offices began to reply directly to married women who had written to them. In 1979 tax offices began writing directly to married women about their tax affairs even when the women had not initiated the correspondence, and the added withholding (the "higher rate" adjustment) necessary for higher earning couples was taken from the husband's rather than the wife's paycheck.[26] The 1978 changes were derided as "cosmetic" and as "a less than adequate response to the growing claims of dissent at the way the present tax system operates between the sexes" by Sir Geoffrey Howe,[27] before he became Chancellor of the Exchequer. The 1979 changes made after he took office were considered by many to be no more radical. Ruth Lister, the Director of the Child Poverty Action Group and author of extensive publications on the need for tax reform in the U.K. says "In essence, not much has changed since the 1918 Taxes Act which defined married women as "incapacitated persons" along with infants, lunatics, idiots and insane persons."[28]

The reform solution supported by many, including the majority who responded to the Equal Opportunity Commission discussion paper,[29] the Women's National Advisory Committee of the Conservative Party,[30] and a committee headed by J.E. Meade of the Institute of Fiscal Studies,[31] is the change (at least for *earned* income) to mandatory individual taxation for everyone, married or single.

Tax status of women at divorce

Another major demographic change which has occurred since World War II in the U.K. has been a rise in divorce rates. Petitions for divorce and nullity of marriage increased from 38,901 in 1946 to 110,722 in 1972.[32] Rates continued to rise in the later 1970s, from 2.56/1,000 mid-year population in England and Wales in 1976 to 3.01/1,000 in 1980.[33] The proportion of divorces between couples with children rose, from 66% of divorces in 1957 to 73% in 1971,[34] and though the rate of remarriage rose somewhat between 1961 and 1970, the remarriage rate of men over that of women remained an almost constant 7%.[35] The resulting growth in the number of single parent families caused sufficient public concern that the government commissioned a White Paper on the subject, the 1974 Finer Report. This report stated, "In round numbers, our terms of reference required us to examine problems peculiar to nearly two-thirds of a million mothers and fathers, though mostly to mothers, who are looking after one million children single-handed.[36] More than five-sixths of the single-parent families in the U.K. in 1971 were headed by women.[37]

The difficulty of enforcing child-support orders has been characterized as intractable because "though divorce and the right to remarry have been with us for a very long time . . . it is only in comparatively recent times that it has been a common thing for people to re-

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[19] In 1974, for example, women earned 60.7% of the average man's hourly wage in manufacturing jobs. International Labour Organization, 1980 *Yearbook of Labour Statistics* 581-585 [hereinafter *ILO Yearbook*].

[20] Women's National Advisory Committee of the Conservative Party, *Women and Tax* (1979), as cited in Lister, 136.

[21] Cmnd 8093, at 7.

[22] *ILO Yearbook* 581-585.

[23] Id. at 442-450.

[24] Cmnd 8093 at 27; see also letter received by the British Equal Opportunity Commission quoted in Lister, at 142.

[25] "The assumption that incomes are effectively pooled within the family is also open to question. What evidence there is suggests that the husband's income is not always shared fairly with the rest of the family so that his income is not necessarily a reliable indicator of the income available to the family as a whole". Lister, 139, citing Equal Opportunities Commission, *Income Tax and Sex Discrimination* (1977).

[26] Cmnd 8093, at 59.

[27] Speech by Sir G. Howe, House of Commons, *Debates* (July 12, 1978, col. 1265), quoted in Lister at 140.

[28] Lister, at 135.

[29] Equal Opportunity Commission, *With All My Worldly Goods I Thee Endow . . . Except My Tax Allowances* 34 (1979).

[30] Lister, at 140.

[31] J. Meade, *The Structure and Reform of Direct Taxation* (1978), as cited in Lister at 141 [hereinafter Meade].

[32] 1 *Finer Report* 41.

[33] United Nations, 1980 *Demographic Yearbook*, 303-304.

[34] 1 *Finer Report* 51.

[35] Id. at 56. The inference is that remarrying divorced men were going outside the "pool" of divorced women to marry never-married women to a greater extent than remarrying divorced women were marrying never-married men.

[36] Id. at 62.

[37] Id. at 22.

marry who have not the means to keep more than one wife,"[38] and, as the Finer Committee pointed out, "Neither in the divorce court, nor in the magistrates' courts . . . has the law found the method of extracting more than a pint from a pint pot." As a result, only 12.5% of woman-headed families with dependent children relied upon maintenance from their ex-husbands in 1971 as their main source of income. Though 35% of them supported themselves mainly from earnings, 50% were supported mainly by Supplementary Benefits (the natonal assistance program that is the direct descendant of the poor laws previously administered by local authorities).[39]

As the number of divorced women with dependent children rose, so did the numbers who received Supplementary Benefits. The numbers rose from 60,000 in 1958 to over 220,000 in 1972[40] to 536,000 in 1975,[41] with almost one half receiving them for over two years.[42] That so many divorced women with children were unable to support themselves from their earnings without Supplementary Benefits no doubt partly results from the wage gap between men's and women's earnings, which decreased from over 50% in 1970[43] to 31% in 1980.[44] Of course, this is partly due to the fact that not all women were able to work full time due to child-care responsibilities. In any event, the average incomes of fatherless families were found by a 1973 study to be less than half those of two-parent families,[45] though almost half of two-parent families had only one wage earner.

The operation of the two system results in the state collecting less revenue after divorces between higher-earning men and lower- or non-earning women. A man earning 12,000 pounds who is ordered to pay 4,000 pounds maintenance, one-third of his income, to his ex-wife can deduct the maintenance payment from his stated gross income, so the state will compute and collect less tax at his high marginal rate. His ex-wife pays at the lower basic rate on her 4,000-pound income. At 1976-77 tax rates, this means a net loss to the Inland Revenue of 1,885 pounds (32% of what it would have collected had there been no divorce). The man's net in-

Table 1
Financial position of husband, wife and public authorities
before and after divorce in the U.K.

H's position if not divorced		H's position after divorce and remarriage		
	pounds		pounds	
Gross earnings	2,100	Gross earnings		2,100
DEDUCT		DEDUCT		
Married man's allowance	1,085	Married man's allowance	1,085	
		Maintenance to wife	799	
			1,785	1,785
Taxable income	1,015	Taxable income		315
TAX PAYABLE AT 35%	355	TAX PAYABLE AT 35%		110
NET INCOME		NET INCOME		
Gross earnings	2,100	Gross earnings		2,100
LESS		LESS		
Tax	355	Tax	110	
		Maintenance	700	
			810	810
TOTAL	1,745	TOTAL		1,290

Husband's net income after divorce is £ 1,745 − 1,290 = £ 455 (or 26%) less than if not divorced.

Ex-wife's position

£ 700 does not bring her above supplementary benefit level for a single person. Hence she receives supplementary benefit (approx. £ 816 p.a. including long-term addition) and rent (say £ 500 p.a.).

Position of public authorities

	pounds
Supplementary Benefits Commission pays wife (approx.)	1,300
LESS contribution from ex-husband	700
	600
ADD tax lost by Inland Revenue (£ 335 − 110)	245
Total contributed by public authorities	845

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[38] *Cockburn v. Cockburn* (1957) 1 WLR 1020, *per* Hodson LJ at 1024-1025.

[39] 1 *Finer Report* 244.

[40] Id. at 245.

[41] Great Britain, Supplementary Benefits Commission, 1976 *Annual Report*, 44.

[42] 1 *Finer Report* 251.

[43] Id. at 259.

[44] *ILO Yearbook*, at 442-450.

[45] "In all areas studied at least half the two-parent families had a usual income of at least £ 20 a week, while the corresponding proportion of fatherless families was nowhere more than 13%. The number of two-parent families with less than £ 10 a week was negligible, but the proportions of fatherless families below this level ranged from 17% to 41%. The report concluded that, even if the sampling method used had resulted in some overstatement of the proportion of very low-income fatherless families, the financial gap between the majority of fatherless families and the majority of two-parent families was still very great." 1 *Finer Report* 259, discussing A. Hunt, J. Fox and M. Morgan, *Families and Their Needs* (1973).

come, however, is reduced by only 13%, from 6,225 pounds to 5,393 pounds.[46]

The net loss to the government is also high where the husband is a low wage earner, since maintenance payments ordered will not be sufficient to bring his ex-wife above the poverty level, and she will qualify for Supplementary Benefits. Table 1 shows another 1976-77 example.[47]

While the tax system *diminished* the adverse fiscal impact on the payer of maintenance after divorce, it increasingly *magnified* the financial difficulties of the non or lower earning custodial parent. The U.K. Family Allowance Act of 1945 had made a (taxable) cash benefit payable for all children except the first, as a means of helping families with minor children. The taxability of the payment (nicknamed the 'clawback' principle) had originally been intended to reduce the value of the allowance for higher income earners and to give maximum benefit to those in greatest need.[48] The way it was intended to work is demonstrated by Table 2, showing the effect of different tax treatments of social benefits.[49]

Table 2
Results of alternative
tax treatments of social benefits, U.K.

Social benefit	Value (in pounds) to taxpayer with marginal rate of tax of: 0%	40%	60%
Tax allowance of 500 pounds	0	200	300
Untaxed benefit of 200 pounds	200	200	200
Taxable benefit of 333⅓ pounds	333⅓	200	133⅓

But since the U.K. tax system was not indexed against inflation and the tax bands were not widened in proportion to the rate of inflation, the clawback acted after the inflationary years of the 1960s and 1970s to tax the cash benefits of parents who previously would have been below the threshold of taxation but were now liable for tax at the beginning rates of 30 and 35% and were in addition liable for a national insurance contribution (NIC).[50] In 1980 it was possible to show "how the tax threshold – the starting point for income tax – has fallen so that it now stands at a level below the official poverty line,"[51] creating what was called the "poverty trap." In addition, in "the decade of the late 1960s to late 1970s income tax allowances were not increased in line with either the price level or average earnings . . . consequently particular categories of taxpayers were hit with exceptional severity . . . [t]hose with . . . a number of child allowances."[52] Though there is no evidence that the costs of raising children dwindled in relation to the costs incurred by single persons, the value of the child tax allowance fell disproportionately in less than 20 years, as follows:[53]

Table 3
Child tax allowances as a percentage of
the single personal allowance

	Under 11 (%)	11–16 (%)	16 and over (%)
1957/58	71.4	89.3	107.1
1976/77	41.0	46.0	50.0
(after clawback)	(34.0)	(38.5)	(42.5)

Since only those with sufficient income to pay taxes can benefit from a tax allowance system – the very poor receiving no benefit because they pay no taxes – a 1972 government Green Paper proposed that there be a system of payment of uniform tax credits or rebates for dependent children. It said:

> The tax credit scheme cannot of itself offer a complete solution to all the problems of poverty. But . . . it offers the prospects of a system of family support which would be easier to understand than the present one, which would provide its benefit largely automatically and which, being integrated with the tax system, would extend the benefit of tax allowance to people who have insufficient income to pay tax. By doing so it would relieve . . . hard pressed families of working age – especially those with children . . . .[54]

It proposed that there be three rates of credit, one for married couples and single parent head of households, one for single people and one for each dependent child. After some indecision and after rejecting the Finer Committee proposal for a guaranteed maintenance allowance for one-parent families, the British government began phasing in a non-taxable cash child benefit scheme over a three-year period, beginning in April, 1977, and phasing out taxable family allowances and child tax allowances. In recognition of the special needs of one-parent families, the cash child benefit for the first or only child in such families was paid at the rate of 1.50 pounds weekly rather than the normal rate of one pound.[55]

Critics have pointed out two things: that the child benefits are below the level of child support paid to claimants of unemployment and sickness and so are still not integrated evenly into the full array of entitlement pro-

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[46] J. Eekelaar, *Family Law and Social Policy* 191-192 (1978) [hereinafter Eekelaar].
[47] Id. at 194.
[48] Id. at 259.
[49] Meade, table 13.5.
[50] The British National Insurance Scheme is a contributory scheme with benefits similar to those of the American Social Security system, but additionally pays benefits for maternity, sickness and temporary disability, covers workers' compensation ("industrial injuries benefits") and unemployment compensation ("unemployment benefit"), and supports the National Health Service. See, e.g., Great Britain, Department of Health and Social Security, *National Insurance Guidance for People Abroad* (Leaflet N138, 1978).
[51] *Taxation and Social Policy* 65 (ed. C. Sandford, C. Pond and R. Walker, 1980), discussing Piachaud, *Taxation and Social Security,* ch. 5 thereof.
[52] Sandford, *Taxation and Social Policy: An Overview,* in *Taxation and Social Policy* 5 (C. Sandford, C. Pond and R. Walker, ed., 1980).
[53] Lister, at 147.
[54] *Proposals for a Tax-Credit System,* Paragraph 115 (Cmnd 5116, 1972) quoted in Sandford, *The Tax Credit Scheme,* in *Taxation and Social Policy* 212 (C. Sandford, C. Pond and R. Walker ed., 1980).
[55] Eekelaar, at 261-262.

grams; and that the child benefits, not being tied to the cost of living index, could again be eroded by inflation. "It is crucial that the benefit should be index-linked in line with other benefits and with the main personal tax allowances. Otherwise it will simply repeat the dismal history of the family allowance scheme."[56]

In 1982-83[57] a single woman head of household with two children and a gross income of 4800 pounds would net 88.8% of her gross, after taxes, NIC and receipt of two child benefits. Because this family qualifies for two child benefits, it is slightly better off than a three-person family with an earning husband, a homemaker wife and one child, which would net 84% of the same gross income. If the husband-wife family had two earners, however, and the same gross income, it would net 96% of its gross income, or 4,797.34 pounds, because of the operation of the wife's earned income allowance and the reduced NIC rate for wives. Table 4 shows the computations for each family. National health insurance payments are included in NIC. Unless these families qualified for a rebate, each would also be liable for "rates" (local government property taxes).

Table 4
1982-83 tax and benefit on gross income of 4,800 pounds

	Single parent head of household	One-earner couple	Two-earner couple
Married man's allowance		2445	2445
Single person allowance	1565		
Additional personal allowance	880		
Wife's earned income allowance			1565
Total allowances	2445	2445	4110
Taxable income	2355	2355	690
Tax at 30%	706.50	706.50	207
NIC[a]	324	324	249.66[b]
Net income after NIC	3769.50	3769.50	4343.34
Child benefit, 1	247	247	247
Child benefit, 2	247		
Available income	4263.50	4016.50	4590.34
Available income as % of gross income	89	84	96

a. Men, single women and divorced women contribute 6.75% of income for National Insurance. Married women and widows contribute 2%. *Britain 1981, an Official Handbook.*
b. Assuming that the husband earned £ 3255 and wife £ 1565.

UNITED STATES

Married women

The history of the taxation of married persons in the U.S. has been "tortuous" and provides "abundant evidence of the inevitable conflict of values" between the individual and the family unit approach.[58] At the outset the U.S. approach was individualistic, with the earliest (1913) tax statute, based on the 16th Amendment, imposing a progressive tax on "every citizen."[59] A 1930 Supreme Court decision[60] confirmed the individualistic approach since it made it impossible for a wage-earning husband to split "his" earned income with his wife and have each of them taxed (at a lower rate) on the half attributed to each.

There were, however, a number of states in the South, Southwest and on the Pacific coast whose property systems were based on continental civil law rather than English common law. In those states, community property law held that each spouse had a present interest in one-half of all income to the community – the marriage – which was to be managed by the husband. After 17 years of debate and conflicting lower-court decisions, resulting from dispute as to whether the husband's broad managerial powers really made *all* community assets effectively his, with his wife having a mere expectancy,[61] the Supreme Court held that where a present vested interest was created by state law, even though the husband had managerial control, "the entire property and income of the community can no more be said to be that of the husband, then it can rightly be termed that of the wife." It concluded that each spouse should be taxed on his or her half of the community income.[62]

One income couples in the community property states had their taxes reduced as a result of this decision, since each spouse paid the same tax as an unmarried person with one-half the aggregate community income. The other major effect was that most couples in community property states with the same aggregate income were treated alike,[63] while taxes varied for couples with similar aggregate incomes in the other states (in which the law treated, and continues to treat, all income as the sole and "separate" property of the spouse who earns it), since they were assessed as individuals.

There was, naturally, a stampede at the state level to share in the income tax advantages of community property. Oklahoma, Oregon, Hawaii, Nebraska, Michigan, Pennsylvania, Massachusetts and New York all took steps toward enacting, or actually enacted, their own community property systems.[64]

In 1941, legislative efforts to find an acceptable solution that would equalize the tax burdens of married couples failed. The House Ways and Means Committee's proposal was that there should be a mandatory joint return, with the couple's aggregate income taxed at the

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[56] Lister at 148.
[57] The U.K. tax year begins April 6. R. Hepker, *A Modern Approach to Tax Law* 1 (1973).
[58] Bittker, *Taxation and the Family,* 27 Stanford L. Rev. 1399 [hereinafter Bittker].
[59] Act of 3 Oct. 1913, ch. 16 sec. II (A) (1), 38 Stat. 166.
[60] *Lucas v. Earl,* 281 U.S. 111 (1930).
[61] *U.S. v. Robbins,* 269 U.S. 315 (1926).
[62] *Poe v. Seaborn,* 282 U.S. 101, 113 (1930).
[63] There was still a difference in the tax liability in community property states between couples whose aggregate income was entirely the fruits of the labor of the partners, and therefore all income of the community, and those couples where one partner had unearned income deriving from separate property, which was separate income taxable to that individual only.
[64] Bittker, at 1412.

same rate as a single person with the same income. The proposal had the disadvantage of penalizing marriage and so constituting a "tax on morality" and a "subsidy to sin."[65] The Senate Finance Committee proposed to tax community income to the one who earned it. This proposal had the disadvantage of effectively raising the taxes owed by one-earner couples in community property states, while leaving untouched the ability of a couple to split its investment income through interspousal gifts. (The splitting of investment income was subject to one-time gift taxes only, when the income-producing property was transferred).

In 1948, Congress finally enacted an aggregation and income-splitting proposal that allowed each couple to pay a tax equal to twice what a single person would have paid on half of their consolidated taxable income. The change gave a tax reduction to many married couples in separate property states, though of course it did not affect the actual ownership of the income by the spouse who earned it. It turned the tide of state conversions from separate to community property, ended the geographic disparity in taxing, and put couples who had only earnings to split in the same position as those who owned investments and had, therefore, been able to split income all along.

Income-splitting was, of course, a tax fiction. No *actual* splitting of income was required in the separate property states, where now men with the same earnings as before paid less in tax because they had non-earning or lower-income wives. Husbands in the community-property states still had sole management and control over the total income and assets of the community. It was natural, therefore, that income-splitting became, after the fact, to be equated with lower tax liability because of family responsibilities.[66]

Beginning in 1951, Congress enacted successive tax relief for heads of households (HOH), first defined as one having a dependent person in the household or a child. Then in 1954 the definition was expanded to include a dependent parent living separately from the wage-earning spouse and a person who was widowed (for two years after the spouse's death). Later, in 1969, after rejecting a proposal which would have expanded the HOH pool to include all single persons over 35, Congress gave partial relief to *all* single persons by changing the tax brackets so that the disparity between liability of singles and marrieds was lessened to no more than 20%. In the same Act, Congress prevented loss of revenue by discouraging married persons with incomes roughly equal to those of their spouses from reducing their taxes by filing separately, through the simple device of taxing married persons filing separate returns at the old pre-1969 single person rate schedule, which offered them no advantage.

By so doing, Congress recreated the "marriage penalty," this time evenly applicable throughout the nation, community and separate property states alike. Instead of married couples in separate property states being taxed less advantageously than those in community property states, and instead of married couples in all the states having the advantage of being able to aggregate their income and being taxed as though wife and husband had each earned and owned one-half of the total, all married couples paid at somewhat higher tax rates (using a different tax table) than all single persons. In 1982, for instance, a single person was liable for $ 1,043 tax on $ 10,000 income (a marginal rate of 19%). A married couple (using a different table) was liable for $ 2,453 tax on a $ 20,000 income (a marginal rate of 22%). This meant that two single persons, each with a $ 10,000 income, who were living together, were liable for less tax ($ 2,086) than the married couple, who in turn were "penalized" by being held liable for $ 367 more than if they were simply cohabiting.

It was soon argued that the marriage penalty caused a disincentive effect on married women's paid employment; that it bore particularly hard on working women who marry higher-earning husbands, in that their marginal tax rate goes up while at the same time they feel obliged by custom to bear primary responsibility for home duties and for any child care required because they chose to take paid work.[67] In a cultural setting in which it was assumed that it was natural for the father to work for pay and for the mother to stay home and care for the children, it was perceived that child care costs incurred when *both* parents were in paid employment were incurred only because *the mother* returned to paid work and should therefore be set off against *her* paycheck.

This furthered the perception that her employment efforts were minimally productive – they were seen as worth only her gross pay (usually considerably less than her husband's because of the wage gap[68]), minus all additional taxes paid (at the husband's marginal rate) and all additional costs incurred because she chose outside work, including all the costs of child care. In this context, in families in which the income aggregation was merely a fiction for tax purposes, and the two incomes largely "owned" separately, both the taxation of married couples as a unit and the marriage penalty would have fallen more heavily on the woman, in that she would net less than if she were single. Even in families where all income was actually combined, it was possible for a married woman's gross earnings of $ 10,000, in 1973, to yield a net increase to the family of only $ 1,600.[69]

Congressional response to the problem of the marriage penalty took the form, in 1983, of a 10% deduction of the smaller of $ 30,000 or the earned income of the lower earning spouse where both worked, filed a joint return and had qualified earned income.[70] (A 5% re-

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[65] Id. at 1409, note 56.

[66] Id. at 1418.

[67] *Hearings on the Economic Status of Women Before the Joint Economic Committee,* 93d Cong., 1st Sess., pt. II, p. 229, cited in Bittker at 1432 [hereinafter *Hearings*].

[68] In 1973 the earnings of women who worked full time, year round were 57% those of men. The median income for women, a larger proportion of whom worked part-year or part-time than men, was $ 2,796, compared with $ 8,056 for men. Women's Bureau, Employment Standards Administration, U.S. Dep't of Labor, Bulletin 297, *Handbook on Women Workers* 127 (1975).

[69] Id.

[70] I.R.C. s. 221 (1982).

duction was allowed in 1982). The impact of this change is to reduce, but not eliminate, the marriage penalty. A 5% deduction from the adjusted gross earned income of a spouse earning $ 9,999.99 meant a reduction of tax liability for a 1982 couple with combined earnings of $ 20,000 from $ 2,453 to $ 2,343, which reduced the marriage penalty from $ 356 to $ 257. The 10% deduction, applicable in 1983, further reduced the penalty to $ 134.

In 1954, Congress added a deduction to the Code for cost of child care because it recognized "that a widow or widower with young children must incur these expenses in order to earn a livelihood and that they, therefore, are comparable to an employee's business expenses."[71] A 1971 amendment broadened it to include higher-income married couples, but left it as an itemized personal deduction of up to $ 400 a month. This was criticized on the ground that most low-income families (for whom the provision was primarily intended) took the standard deduction and did not itemize, and that "When itemized child care expenses are treated as a deduction, resultant tax savings are a function of each taxpayer's taxable income. If such expenses were treated as a credit, all taxpayers incurring the same expenditure could reap the same benefit."[72]

This criticism of the child care deduction could have been applied with equal cogency to the personal exemptions afforded each taxpayer and the taxpayer's dependents. Certainly the tax treatment of the costs of raising children has received little analytic legislative attention in the U.S. In 1917, Congress authorized heads of families to deduct $ 200 for each dependent child under 18, and for older children if they were unable to support themselves because defective.[73] This method of allowing for the reduction of taxpaying capacity on the part of parents has remained essentially unchanged since then. The amount of the exemption has risen with inflation so that in 1983 a parent is able to deduct $ 1,000 for each dependent child.

In 1982, the allowance for child care expenses *is* a credit, not a deduction. The Code allows a tax credit for 30% of actual child care expenses where both parents, or a single parent, worked for an adjusted gross income of less than $ 10,000, up to a maximum of $ 2,400 for one child or $ 4,800 for two or more children.[74] The percentage allowed for the credit is reduced in graduated steps as the parents' income increases to $ 28,000, after which it remains at 20%. However, one commentator's criticism still applies: it "helps middle-income families, not families in the lower income brackets who . . . are not subject to tax at all . . . it seems to me that, if the Nation believes that two-earner married couples with low incomes need help for child care, the child care could be provided either by opening up facilities for the use of lower income families, or through a voucher system."[75]

Tax status of women at divorce

The extensive demographic changes of the twentieth century in the U.S. – similar in pattern to those described in the U.K. – have produced almost no changes in the tax laws. The widespread misery of the Depression resulted in social insurance programs that are perceived as self-financing and that are "failing" if they are not self-financing.[76] The rise in divorce, the numbers of children of divorce, the lack of sufficient support from the absent parent and the low earning capacity of the single parent (almost always a woman) that resulted in the pauperization of greatly increased numbers of women and children, and their dependence on Aid to Families with Dependent Children (AFDC), led to a brief and non-productive legislative flirtation with the idea of a negative income tax in 1971. This proposal, for a Family Assistance Plan (FAP), was defeated by an alliance of advocates for the poor, who felt that the minimum income thresholds proposed were far too low, and those who were alarmed by the rising costs of AFDC and preferred the introduction of punitive measure to discourage families from going on welfare.[77]

The demographic trends which gave rise to the FAP proposal have continued and the problems they have created now stand at a somewhat higher order of magnitude. The upward divorce trend that began in 1963 with a rate of 2.3 per 1,000 population and which reached 4.0 during the FAP debate in 1972 rose to 5.31 in 1979.[78] The percentage of U.S. families headed by women rose from 9.3% in 1960 to 10.8% in 1970 to 14.6% in 1980.[79] The impact of divorce on the incomes of the women involved remains harsh, and contrasts with that of men as Table 5, published in 1981, demonstrates.[80]

Weitzman's first explanation offered for the striking contrast in the economic experience of former husbands and wives is that "the wife typically assumes most of the costs of raising the couple's children. Thus, her need for help and services increases as a direct result of her becoming a single parent, while at the same time her income declines."[81] Only 59% of women with custody of the children were awarded any child support. Of this group only 49% received the full amount awarded while 23% received only partial payment and 28% received nothing.[82] In 1979, the average income of families headed by divorced women was 51.7% that of two-parent families, while that of the families of women who were separated but not yet divorced stood at 35%.[83] In 1981, the difference was still wider, with two-

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[71] *Hearings* at 221-288.

[72] Blumberg, *Household and Dependent Care Services: Section 214,* in *Hearings* 240, 253.

[73] Act of 3 Oct. 1917, ch. 63, sec. 1203(1), 40 Stat. 300.

[74] I.R.C. sec. 44A.

[75] *Hearings* 255 (Statement of Joseph Pechman, Director, Economic Studies, The Brookings Institution).

[76] "A Debt-Threatened Dream", Time, 24 May 1982 at 16.

[77] Williams, *Poverty & Welfare: A Women's Issue,* 1974 Women's Rights Almanac 545.

[78] U.S. Nat'l Center for Health Statistics, cited at 1974 *Women's Rights Almanac* 479 (1972 figure), and in 1981 *Statistical Abstract of the United States* 82 (1979 figure).

[79] 1981 *Statistical Abstract of the United States* 48.

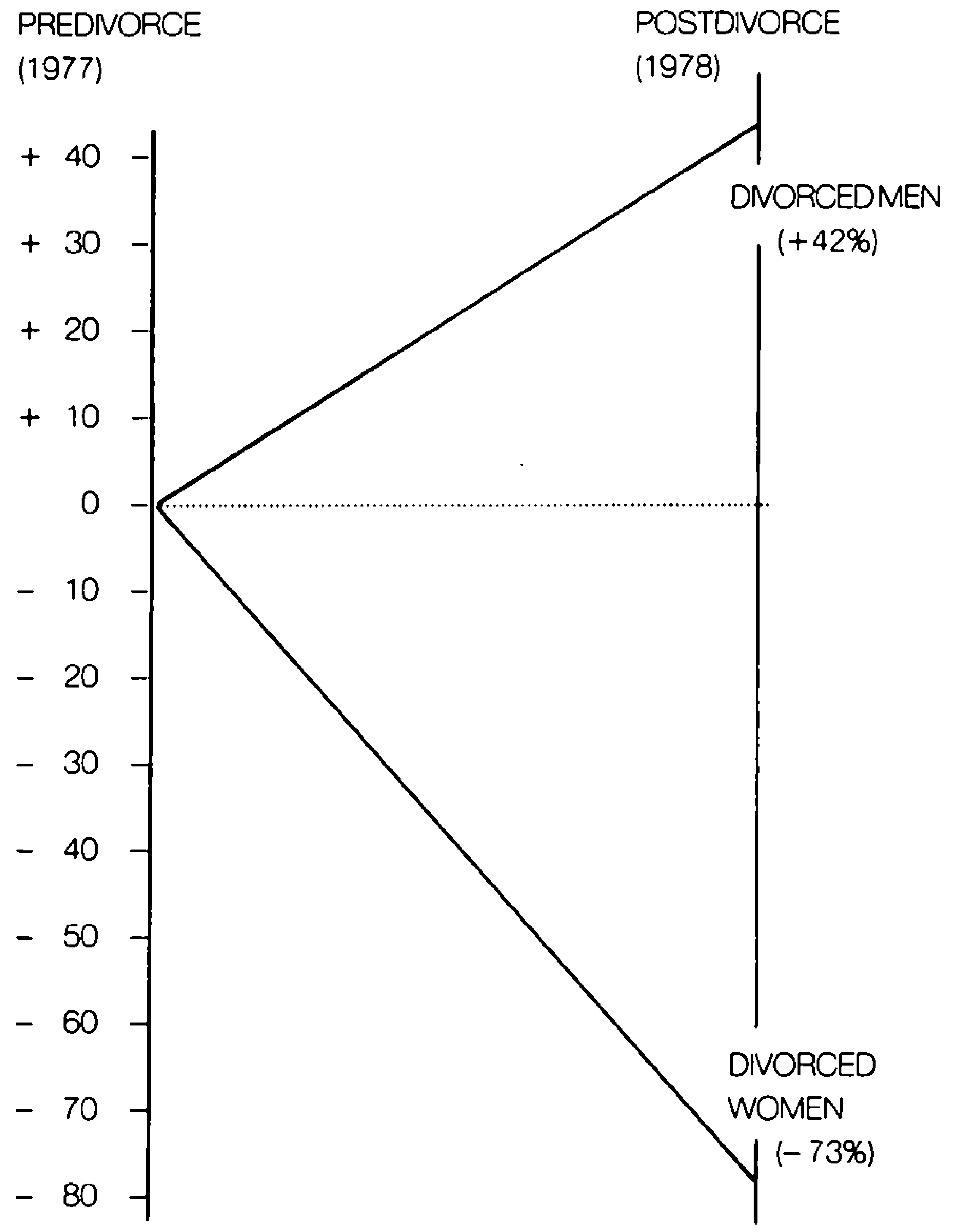
[80] Weitzman, *The Economics of Divorce: Social and Economic Consequences of Property, Alimony and Child Support Awards,* 28 U.C.L.A. L. Rev. 1250 (1981) [hereinafter Weitzman].

[81] Id. at 1251.

[82] I. Garfinkel, *Child Support: Weaknesses of the Old and Features of a Proposed New System* 1-4 (1982).

[83] 1981 *Statistical Abstract of the United States* 439.

Table 5
Percent change in standard of living of divorced men and women in California
(one year after divorce)



(Based on weighted sample of interviews which divorced persons approximately one year after legal divorce, Los Angeles County, 1978).

* Income in relation to needs with needs based on U.S. Department of Agriculture's low standard budget.

A Lower Standard Budget was calculated for each family in our interview sample three different ways: once for the predivorce family, once for the wife's postdivorce family, and once for the husband's postdivorce family. The income over needs for each family was then computed. Membership in postdivorce families of husbands and wives included a new spouse or cohabitor (where applicable), and any children whose custody was assigned to that spouse.

parent families averaging $ 25,065 and female-headed families averaging $ 10,960.[84]

Between 1960 and 1981 the number of persons in poor families headed by women rose 54%, while the number in families headed by men dropped 50%.[85] The number of people living below the poverty level in the U.S. in female-headed households rose from 10.4 million in 1969 to 13.1 million in 1979, and the percentage of all those who lived below the poverty level who were in female-headed households rose from 43% in 1969 to 51% in 1979.[86] The numbers of woman-headed families in poverty is reflected by the rise in those who qualified for Aid to Families with Dependent Children (AFDC). Nearly half of all children living in woman-headed families were on AFDC in 1982.[87] The total number of AFDC recipients, which rose from over 9 million in 1970 to over 11 million in 1975, remained at over 11 million in 1980, and dollar payments rose from less than $ 5 billion (1970) to $ 12.5 billion in 1980.[88]

The numbers of AFDC recipients remained almost constant despite a nationwide, federally-funded program begun in 1975 to locate absent parents and get them to pay the child support that they owed.[89] Even with the help offered by the federal program, child support was collected from only 10% of absent fathers of children on AFDC in 1981.[90] In that year, Wisconsin, with one of the most effective programs in the nation, collected child support from the absent fathers of 15% of AFDC families and recovered 8% of AFDC expenditures.[91]

There is evidence that even if all judicially-ordered alimony and child support awards were paid in full there would still be very large numbers of woman-headed families in need of public support. This is partly because alimony is rarely awarded at all in the U.S. today.[92] It is partly because child support awards, though they vary in amount from one jurisdiction to another,[93] bear more relation to the perceived ability of the payor than to the needs of those who are to receive payment.[94] It is also partly because of the low earning power of the women who are the custodial parents:

> Sex stereotyped education, biased vocational counseling, sex segregated jobs and wage discrimination, although against the law, continue to influence the employment and earnings of women.[95]

The problems of a disproportionate number of these low-income women heads of families are compounded by their race: while the poverty rate of *all* woman-headed families in 1981 was 34.6%, for those of them headed by Blacks it was 52.9% and for those of them headed by Hispanics 53.2%.

In the U.S., means-tested welfare programs are not integrated with the tax system, but the tax system incorporates a number of allowances that are a form of public

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[84] *Outlook Gloomy for Females Who Head Households,* The Capital Times, 12 April 1983, p. 15, col. 1.

[85] Id.

[86] 1981 *Statistical Abstract of the United States* 447.

[87] Garfinkel, *supra.*

[88] Id. at 906.

[89] Title IV(D), Social Security Act.

[90] Garfinkel, at vii.

[91] Id.

[92] A study done for the International Women's Year Commission in 1975 showed that 14% of divorced or separated women were awarded alimony. National Commission on the Observance of International Women's Year, ". . . *To Form a More Perfect Union . . .* ", *Justice for American Women* 338 (1976).

[93] M. Melli & S. Zink, *Alternatives to Judicial Child Support Enforcement* (Unpublished paper presented at the Int'l Soc. on Family Law, 11-16 June 1982), at 3.

[94] Weitzman, at 1241.

[95] *Outlook Gloomy for Females Who Head Households,* The Capital Times, 12 April 1983, p. 15, col. 1, quoting U.S. Commission on Civil Rights, *A Growing Crisis: Disadvantaged Women and Their Children* (1983).

expenditure.[96] These public expanditures are regressive in effect, with 0.2% of the benefits enjoyed by the poorest 18% of families and 42% enjoyed by the top 1.2% of families in 1972.[97] For example, in 1983 personal exemptions of $ 2,000 for two children are worth $ 0 to a parent on AFDC with no tax liability, $ 360 in taxes not paid to a single parent earning $ 10,560, and $ 960 to a couple with an aggregate income of $ 89,600. As in the U.K., alimony awards are "tax advantages" to the paying spouse and represent a net tax loss to the U.S. treasury since alimony paid is taxable to the (lower income) receiver and deductible by the (higher income) payor. Child support payments, on the other hand, are not deductible to the payor.[98]

In the U.S. tax system, a family of three persons is better off if both parents are present than if it comprises a single parent with two children. This is so whether or not the children are in their teen-age years, and as, or more, expensive to maintain than adults. As Table 6 demonstrates, a married couple with one child and income of $ 10,560 would pay $ 540.40 in federal taxes for 1982, and if only one parent were working would have no child care costs. A single parent with two children with the same gross income and number of personal exemptions would pay $ 715.60 in federal taxes, since she qualifies for a head of household allowance ($ 2,300), not the married couple's zero bracket amount ($ 3,400). A two-earner couple with the same gross income would be best off, since that family qualifies for the married couple's zero bracket amount, the lower earning spouse deduction and an earned income credit.

The single parent will, in addition, have $ 707.52 withheld for social security,[99] $ 192 for state taxes,[100] and almost surely $ 200[101] as her health insurance contribution. She will actually see $ 8,744.88.

If her children are 8 and 10, and she had after-school child care expenses of $ 157.50 monthly (at $ 2 an hour for 2½ hours, five days a week) she could claim 29% of this amount as a tax credit ($ 548.10, annualized), so she would net $ 9292.98.

If she were to have an emergency and seek means-tested help, she would discover that she does not qualify for Food Stamps since her gross income, at $ 880 monthly for three persons, exceeds the program's upper monthly income limited for a group of three persons ($ 766).[102] She would pass the first net for AFDC eligibility (the upper limit is $ 888 monthly for a group of three). From her gross income of $ 880 monthly she would be allowed to deduct her child care expense of $ 157.50 and the standard earned income deduction of $ 75 (which, notionally, is an allowance for all withheld taxes and all work-related expenses). With only these deductions, she does not pass through the second net, since her net ("budgetable") income exceeds the "assistance standard" of $ 592 for a group of three. She would qualify for aid only if she were in the first four months of earning income, and had not previously received AFDC for a period of 12 months, since $ 30 plus one-third of her gross income would then also be deducted from her gross income to reach a budgetable income of $ 324.50 monthly. That would be deducted from the "family allowance"[103] and she would receive $ 178.50 (the difference) cash each month (and she and her children would be eligible for medical assistance without a deduction).

Table 6

1982 tax on gross income of $ 10,560[b]

	Single parent head of household	One-earner couple	Two-earner couple
Zero bracket amount	2,300	3,400	3,400
Personal exemptions	3,000	3,000	3,000
Lower-earning spouse[a] deduction	–	–	220
Total deductions and exemptions	5,300	6,400	6,620
Taxable income	5,260	4,160	3,940
Tax before credits	716	540	508
Earned income credit[a]	–	–	478
Tax after credit	716	540	30
Income after tax	9,844	10,020	10,530
Social security	707	707	707
Health insurance	200	200	200
State tax	192	111	99
Available income	8,745	9,002	9,523
Available income as percent of gross	82.8	85.2	90.2

a. Assumes that lower-earning spouse grossed $ 4,400, and higher-earning spouse $ 6,160.

b. If child-care costs and tax credits are assumed for the single parent and the two-earner couple, with annual child-care cost of $ 1,890, their available incomes will be, respectively, $ 7,403 (70.1% of gross) and $ 8,141 (77.0% of gross).

Though hardly affluent before the taxes and contributions required of her, this hypothetical single woman with two children has her gross income reduced by 17.2% if she pays for no child care, and by 29.9% after she pays for the child care that enables her to work.

As some tax critics have commented, "much of the apparent illogic of the present pattern of adjusting tax burdens for family circumstances can best be understood as the fruit of *ad hoc* changes in the tax base or the taxable unit rules in order to correct for unfairness caused by defects in the attribution rules" and has been characterized by an "almost total lack of scholarly concern for the policy choices implicit in the rules."[104]

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[96] "[T]hrough various special exemptions, deductions and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures . . ." S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973) at 3.

[97] Surrey, at 71. At the time, he was Assistant Secretary, U.S. Treasury.

[98] Nor is the payor usually entitled to a personal exemption in respect of the child for whom support payments are being made. I.R.C. sec. 152(e) (1982).

[99] At 6.7% of gross income.

[100] Assumes Wisconsin taxpayer credited for rent at $ 300 a month, and no homestead credit.

[101] Approximate state employee contribution for family coverage.

[102] Wisconsin Department of Health & Social Services. *Food Stamp Handbook.*

[103] $ 503, if they are residents of a populous Wisconsin country. Wisconsin Department of Health & Social Services, *Income Maintenance Handbook.*

[104] McIntyre & Oldman, *Taxation of the Family in a Simplified Income Tax,* 90 Harv. L. Rev. 1574.

SWEDEN

Married women

The tax expenditure conceptual approach that views taxes not just as revenue collecting devices but as tools to effect desired social ends was developed in the U.S. in 1973.[105] It has been increasingly used to analyze tax expenditure proposals contained in the U.S. international tax rules,[106] but not consistently applied there with respect to articulated social policies for taxation and the family. In Sweden, on the other hand, there have been extensive public debates and for a number of years the tax and social benefit policy choices have been made with conscious regard to their impact on the relations between individuals and families.

It was in 1934 that the Swedish government began to use deficit financing as an instrument of economic policy. The reaction to the widespread suffering during the Depression helped social welfare services break with the tradition of poor relief and laid the foundation for today's comprehensive income redistribution program. Sweden came early to the conclusion that social welfare measures not only ameliorated individual deprivation and poverty, but had a beneficial impact on society as a whole. Alva and Gunnar Myrdal's work drawing attention to the difficult economic conditions for large families and the low birthrates led to the initiation of cash benefits as children's allowances in 1948. Housing and employment, which had become part of the government's social welfare system during the Depression remained very important in the 1960s when there was a major population migration from the rural areas to the cities creating needs for new housing units at affordable prices.[107]

During this boom period, there was a great need for labor, so that both men and women were able to find work and women were able to obtain better treatment on the job. The availability of relatively convenient conception control in the form of the pill, combined with the new economic independence of men and women and the break in family ties that accompanied migration to the cities, contributed to changes in what has been described as "the basic social unit of which one is ordinarily a member, the family."

The number of unmarried cohabiting couples and of divorces increased, the number and proportion of children born outside marriage increased, and the number of marriages began to decrease.[108] By 1969, a number of government commissions had made proposals to redefine the family in the light of the new realities. Summarized, they were that:

(i) every adult, married or unmarried, should be responsible for his or her own maintenance;
(ii) marriage should be a voluntary form of personal relationship between independent people;
(iii) no form of personal relationship should be favored over any other; and
(iv) children's emotional needs should be satisfied outside the family as well as within.

The changing mores are clearly shown by a 1974 survey[109] of married and cohabiting couples, who were distributed by age as follows:

Table 7
Percentage of married and cohabiting couples in Sweden 1974, by age group

Age	Married couples %	Unmarried cohabiting couples %
55+	97	3
45–54	97	3
35–44	91	9
25–34	80	20
18–24	47	53

The trends can also be seen in the national statistics for births, marriages and divorces, and in the number of children born of unmarried parents, shown in Table 8. The divorce rate in urban areas is three times as high as in rural areas. The increase in marriages and divorces in 1974 has been attributed to the fact that it was in that year that the 1969 proposals took effect with regard to marriage and divorce.[110]

Table 8
Marriages, divorces and children born of unmarried parents in Sweden 1966-79

	1966	1969	1973	1974	1977	1979
Marriages (in thousands)	61	49	38	45	40	40
Divorces (in thousands)	10	12	16	27	20	21
Children born of unmarried parents (%)	10	18	–	34	–	35

The separate taxation of earned income that came into force in 1971 modified the basic system of rules for income tax that had been originally provided for in the Municipal Tax Act of 1928. It reflected the growing consensus expressed by various commissions that the law should be as neutral as possible with respect to men and women and to unmarried and married couples. In 1965, the government had appointed an expert committee to consider alternative methods by which the operative joint taxation system (similar to that described in the U.K.) could be replaced by individual taxation. Its recommendations were accepted by Parliament in 1970 and the major changes then put into place form the out-

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[105] Surrey, *supra*.

[106] P. McDaniel and H. Ault, *Introduction to U.S. International Taxation 199 (1981)*.

[107] L. Holgersson & S. Lundstrom, *The Evolution of Swedish Social Welfare* 9 (1975).

[108] E. Ekselius, *Living Together – Personal Relationships in Sweden* 3 (Current Sweden No. 263, 1980).

[109] Id.

[110] A. Agell, *Social Security and Family Law in Sweden* 149-150 (Reprint from *Social Security and Family Law*, ed. A Samuels (United Kingdom Comparative Law Series, Vol. 4, 1979)) [hereinafter Agell].

line of the system today.[111] All earned taxable income is taxed to each individual, regardless of sex or marital status. There is a local tax at a flat rate of 26 to 30% according to the municipality that receives it. There is also a progressive state tax with rates on a single table ranging from 2 to 58%, which has been indexed since 1978. In that year, every employed individual was allowed a basic deduction of 4,500 Skr. (Skr. = Swedish kroner), which declined by 20% of any income received over 30,000 Skr.to vanish at 52,500 Skr.

In 1980, Sweden had a number of additional non-means tested, indexed entitlements and benefits integrated within its tax system. Where one of two cohabiting parents or a spouse had no assessed earned income, the other received a tax *credit* of 1,800 Skr. The lower-earning partner was also allowed a gainful employment deduction of 25% on income earned to a maximum of 2,000 Skr. a year. Both benefits – the reduction and the deduction – are available to the single parent. A general child allowance of 2,800 Skr. a year for each child is paid to parents in monthly installments. There is a state-municipal housing allowance of 80% of actual housing costs over 400 Skr. a month (1979), up to a certain limit. A universal parenthood benefit package allows leave of absence from work (at 90% pay) for up to six months at a child's birth and an additional six months before it reaches the age of 8, up to 60 days leave of absence at 90% pay each year to look after a sick child, and the right for the parent of an under-8-year-old to limit his or her employment to six hours each workday. A single person may take advantage of all the benefits; a couple may share them as they wish.

Tax status of women at divorce

The granting of alimony is a dying practice in Sweden. The basic idea behind Swedish alimony rules is that

> all divorced spouses should in principle be ready to support themselves through their own work, and that alimony should above all have the object of helping them through a transition period.[112]

In 1971, alimony was awarded in one in ten divorces, and in 50% of the cases it ceased within a four-year period.[113]

Since 1978 there has been a legislated formula for computing an absent parent's liability for child support. Each child is estimated to need 0.6 of the basic sum (4,900 Skr.).[114] This is to be met proportionately from the parents' incomes, after their reserved amount for living (1.2 basic sums) and cost of dwelling has been set aside. Where an absent parent's child maintenance payment is unavailable[115] or insufficient,[116] the government automatically pays the custodial parent a maintenance

Table 9
Sample budgets (income, consumption & savings) for five Swedish households, 1980 before and after government transfer programs (in Skr.)

Type of household	Working income or pension	Housing allowance	Child allowance	Child support or advance allowance	Pension supplement	Less tax	Net income available for savings or consumption	Food	Housing	Clothing	Child care	Miscellaneous
Industrial worker (2 adults, 2 children aged 5 and 10)	60,000	7,080	5,600	–	–	18,000	54,680	21,200	13,500	6,000	–	13,980
White-collar worker, two-income earners, (2 adults, 2 children aged 4 and 6)	67,000 48,000	–	5,600	–	–	23,600 13,300	83,700	19,300	16,000	6,000	7,900	34,500
White-collar worker (2 adults, 2 children aged 16 and 18)	132,000	–	4,200	–	–	68,900	67,300	25,700	16,000	7,200	–	18,400
Single parent (1 adult, 2 children aged 8 and 10)	48,000	8,880	5,600	11,920	–	11,500	62,900	16,500	13,500	5,400	–	27,500
Old age pensioner (1 adult)	14,155	7,500	–	–	5,513	–	27,168	7,300	7,500	1,600	–	10,768

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[111] M. Norr, C. Sandels and N. Hornhammer, *The Tax System in Sweden* 79 (1972).

[112] Agell, at 159.

[113] Id.

[114] The basic sum is an index-regulated amount that originated in the 1962 National Insurance Act as the amount needed for retirement on an old-age pension, and has since been used in other benefit formulas. In 1980 it was set at Skr. 14,900.

[115] Compared with the U.K. and the U.S., Sweden has a high rate of compliance with support orders. A 1975 study showed that 60% of all maintenance payments for children of divorce and 57% of children born outside marriage were current four years after the separation. 25% or fewer absent parents paid less than 30%. Agell, at 180-181.

[116] In Sweden, parents no longer have an *unconditional* duty to maintain a child under 16, but a duty that is tied to their capacity. The 1978 Code on Parents and Children reads:
The parents shall jointly be responsible for the maintenance of the children according to what is reasonable with respect to the needs of the child and the economic situation of the parents . . . the costs of the maintenance of the child shall be shared by each of the parents according to his or her ability. Ch. 7, s. 1, as quoted in Agell at 160-161.

advance allowance of up to 0.4% the basic sum each year.[117] Maintenance payments are deductible to an absent parent (up to a maximum of 3,000 Skr.annually) and not taxed to the custodial parent.

There are, additionally, a number of benefits available on a sliding scale, according to need. There are public child care facilities that give preference to single and low income parents. In 1980, charges ranged from 3 Skr. a day per child for parents with incomes below 1,500 Skr. a month up to 47 Skr.a day where the parental income was over . 13,700 Skr. a month. Low income persons are eligible for an additional housing allowance for each child (105 Skr. a month, in 1979). General Social Assistance (available from the municipalities) is used by 5 to 6% of the population each year.[118]

The income-distributive effects of these tax and social benefit provisions are demonstrated in Table 9.[119]

The Swedish single parent of an 8 and 10-year old, with an income of 48,000 Skr. has a gain of 31% before child care, over her gross income instead of the drop of 17.2% experienced by her American counterpart (see Table 14).

DISCUSSION

It has been said that, "the most fundamental step in constructing a system of progressive personal income taxation is the choice of the basic economic unit" whether it is to be the individual, the spousal unit, the nuclear family or the household."[120]

The three countries reviewed each tax married women differently and explain the difference by reference to different principles. The normative ideal put forward by some feminists in the U.K. and the U.S., who admire what Sweden has achieved in the equal rights arena is that in which each human being is recognized as having her or his own integrity and independence and so is taxed individually regardless of marital status. This represents the antithesis of the ideal of the family as a unit, eloquently expressed by the 1966 Canadian Royal Commission on Taxation:

> Taxation of the individual in almost total disregard for his inevitably close financial and economic ties with the other members of the basic social unit of which he is ordinarily a member, the family, is in our view a striking instance of the lack of a comprehensive and rational pattern in the perfect tax system . . . We believe firmly that the family is today, as it has been for many centuries, the basic economic unit in society. Although few marriages are entered into for purely financial reasons, as soon as a marriage is contracted it is the continued income and financial position of the family which is ordinarily of primary concern, not the income and financial position of the individual members. Thus, the married couple itself adopts the economic concept of the family as the economic unit from the outset.[121]

No one disputes that there should be vertical equity in a tax system – that is, progressivity of overall contribution rates or greater amounts paid by those who have more money and thus greater ability to pay. Nor does anyone dispute that there should be horizontal equity – that is, that those in similar circumstances should make similar overall contributions and receive similar benefits. The crux of the dilemma is that the perception of two individuals as being in the same, or similar, circumstances depends on whether they are seen as individuals or as part of a unit.

The problem with treating couples with the same overall income equally is that this conflicts with the progressivity of taxation when viewed from an individual standpoint, and either makes marriage a tax boon or exacts a marriage penalty, depending on the interaction of individual circumstances and the tax rates.

The incompatibility between the goals of a marriage-neutral system and one that gives equal treatment to equal-income married couples has been succinctly demonstrated through the Tables 10 and 11.[122]

Table 10
Hypotyhetical income and taxes before marriage

	Taxable income	Tax
Alpha	$ 10,000	$ 1,000
Beta	$ 10,000	$ 1,000
Theta	$ 4,000	$ 400
Zeta	$ 16,000	$ 2,500

Table 11
Effect of marriage on taxes

	Marriage will have the following effect on the tax burden shown in Table 1:	
If the tax on married couples with $ 20,000 of taxable income is:	Alpha-Beta	Theta-Zeta
1. Less than $ 2,000	Decrease	Decrease
2. $ 2,000	No change	Decrease
3. More than $ 2,000 but less than $ 2,900	Increase	Decrease
4. $ 2,900	Increase	No change
5. More than $ 2,000	Increase	Increase

There has been a marked trend in the past 13 years to conversion from compulsory joint to compulsory indi-

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[117] The computations can get complicated. A payor is allowed an additional 0.6 basic sum for a non-wage-earning parent of a subsequent child in a later household. Where there are multiple children (and multiple households) the basic sums of 0.6 per child needing maintenance are aggregated and apportioned between each set of biological parents, according to their income. Agell, at 164.

[118] Agell, at 175.

[119] *The Economic Situation of Swedish Households* 2 (Fact Sheets on Sweden, 1980).

[120] *Hearings*, at 230 (Prepared statement of Grace G. Blumberg).

[121] 3 Royal Commission on Taxation (Carter Commission) *Report* 123 (1966).

[122] Bittker, at 1396 and 1397.

vidual taxation.[123] The move away from spousal aggregation has gone hand in hand with a growing concern about the rights of married women, and has been strongly supported by many advocates of women's equality.[124]

A detailed OECD study of its member nations in 1977[125] cast doubt on the notion that greater equality necessarily followed the change from an aggregate to individual taxation system. The OECD's Committee on Fiscal Affairs reported that

> a move from joint to individual taxation (whether compulsory or optional) has very different results in different countries. In Germany, it normally pays no one to opt for separate taxation, in the United States it pays practically no one, and in the U.K. it pays only the higher income groups. But the move to individual taxation in the Netherlands and Sweden did benefit most two-earner families, and in Belgium virtually all two-earner families. This rather bewildering variety of results between countries is due to the interaction of the tax unit with other features of the income tax system.[126]

The custom, still alive and well in the U.K. and not quite dead in the U.S.,[127] of presuming the male marital partner to be the family leader, its guardian and financial representative is shared by other nations and cultures. This presumption can lead to husbands being allotted more generous credits or allowances than their wives in mandatory individual taxation jurisdictions as well as in jurisdictions where the couple's income is

Table 12
O.E.C.D. countries with income tax systems under compulsory individual taxation, 1974[128]

	When wife does not work husband gets:			When the wife works the position is:		
		Allowances for:		Basic allowance given to working wife	Change in couple's reliefs for:	
	Basic allowance	Marriage	Children		Marriage	Children
Australia	None*	Tax* allowance	Tax* allowance	None*	Husband loses	No change[4]
Austria	Fixed amount plus tax credit of fixed amount	Tax credit	Tax credit	As husband	Husband loses	Credit shared[5]
Canada	Fixed amount	None	Tax allowance	As husband	No change	Additional tax allowance[3]
Denmark	Fixed amount*	Tax* allowance	None	As husband	Husband loses[3]	No change
Greece	Income related[1]	Tax allowance	Tax allowance	As husband	No change	No change
Japan	Income related	Tax allowance	Tax[2] allowance	As husband	Husband loses	No change
Netherlands	Fixed amount	Tax allowance	Tax allowance	Smaller than husband's	No change	No change
Sweden	Inversely related income*	Tax credit	None	As husband	Reduced according to how much wife earns	Additional tax allowance[3]

1. One third of salary to maximum of 40,000 drachma.
2. Third and subsequent child only.
3. See Annex I for full details.
4. Assuming husband earns more. Otherwise, allowance shared.
5. Wife may renounce option if she pays no income tax.

* Changes since 1974.

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[123] In 1970 Denmark converted from compulsory joint to compulsory individual taxation. Sweden followed in 1971, Austria and the Netherlands in 1973. Finland and Belgium scheduled similar conversions for 1976. Only Italy made a change in the other direction in 1974, for couples whose joint income exceeded 5M lire.

Organisation for Economic Co-operation and Development, *The Treatment of Family Units in OECD Member Countries under Tax and Transfer Systems: a Report by the Committee on Fiscal Affairs* 15 (1977) hereinafter OECD.

[124] In 1973 the Commission on the Status of Women in Ireland recommended a change to individual taxation, OECD, at 15; so also did a feminist testifying at congressional hearings on the economic status of women who said "Aggregation creates . . . a strong work disincentive for potential or actual secondary family earners, Blumberg *supra* note 120. A 1980 Swedish Institute publication stated:

Working women became steadily more numerous during the 1970s . . . probably the most decisive factor in accelerating this trend was the tax reform of 1970, which established the principle that every individual is independent and should be self-supporting . . . ." *The Economic Situation of Swedish Households* 2 (Fact Sheets on Sweden, 1980).

In 1981, the Director of the Program of Research on Women and the Family, The Urban Institute, argued for the adoption of mandatory individual taxation at a conference sponsored by the American Enterprise Institute for Public Policy Research. J. O'Neill, "Family Issues in Taxation", in *Taxing the Family (R. Penner ed., 1983), 1.*

[125] OECD, supra.

[126] OECD, at 20.

[127] In March 1980, of 48.1 million U.S. households where both spouses were present, 46.5 said that they were male-headed and 1.6 said they were female-headed. 1981 *Statistical Abstract of the United States* 48. It was only in the 1980 Census that the forms were changed so that the male adult of a family was not automatically considered its head. The Wisconsin income tax form still lists husband and wife in that order.

[128] OECD, at 24.

aggregated. Table 12 shows that in OECD countries that had compulsory individual taxation in 1974 a working woman's basic allowance was smaller than her husband's in the Netherlands. It demonstrates also that although in some countries the husband may lose his marriage allowance when his wife takes paid employment (Australia, Austria, Denmark, Japan) or have it reduced (Sweden) in others he may still qualify for it (Canada, Greece, Netherlands) even though there is arguably no need for a more generous allowance because the taxpayer is not supporting an economically inactive spouse. It is clear from this table that a mandatory individual tax system is not necessarily either marriage-neutral or gender-neutral.

It is also clear that it is a wasted exercise to attempt to gauge the impact of a tax system in isolation. Progressivity is affected not only by aspects of the tax system – by preferred treatment for the person presumed to be the head of the family, the choice of tax unit, the tax rates, the income brackets, allowances, exemptions, deductions and credits – but by different kinds of requirements for social security contributions. Social security contributions can be partially integrated with the income tax (as in the Nordic countries), partly flat rate (as in Canada, Ireland and, until recently, the U.K.), proportional to gross pay, with no upper ceiling (Italy, Switzerland) or with a ceiling (most OECD countries, including the U.S.). They can also be non-deductible (as in Denmark, Norway, Portugal, Spain, the U.K. and the U.S.) or deductible. The size of the social security contribution relative to income and to tax due can also vary, so that at the lower levels of income an employee's contribution exceeds her or his income tax, as was true in 1974 in France, West Germany, Italy, the Netherlands, Switzerland and the U.S.[129] Chart I[130] shows the differential impact of income tax and social security contributions on different levels of income earned by women in 1974 whose husbands earned a wage equal to that of an average production worker (APW) in his own country for that year.

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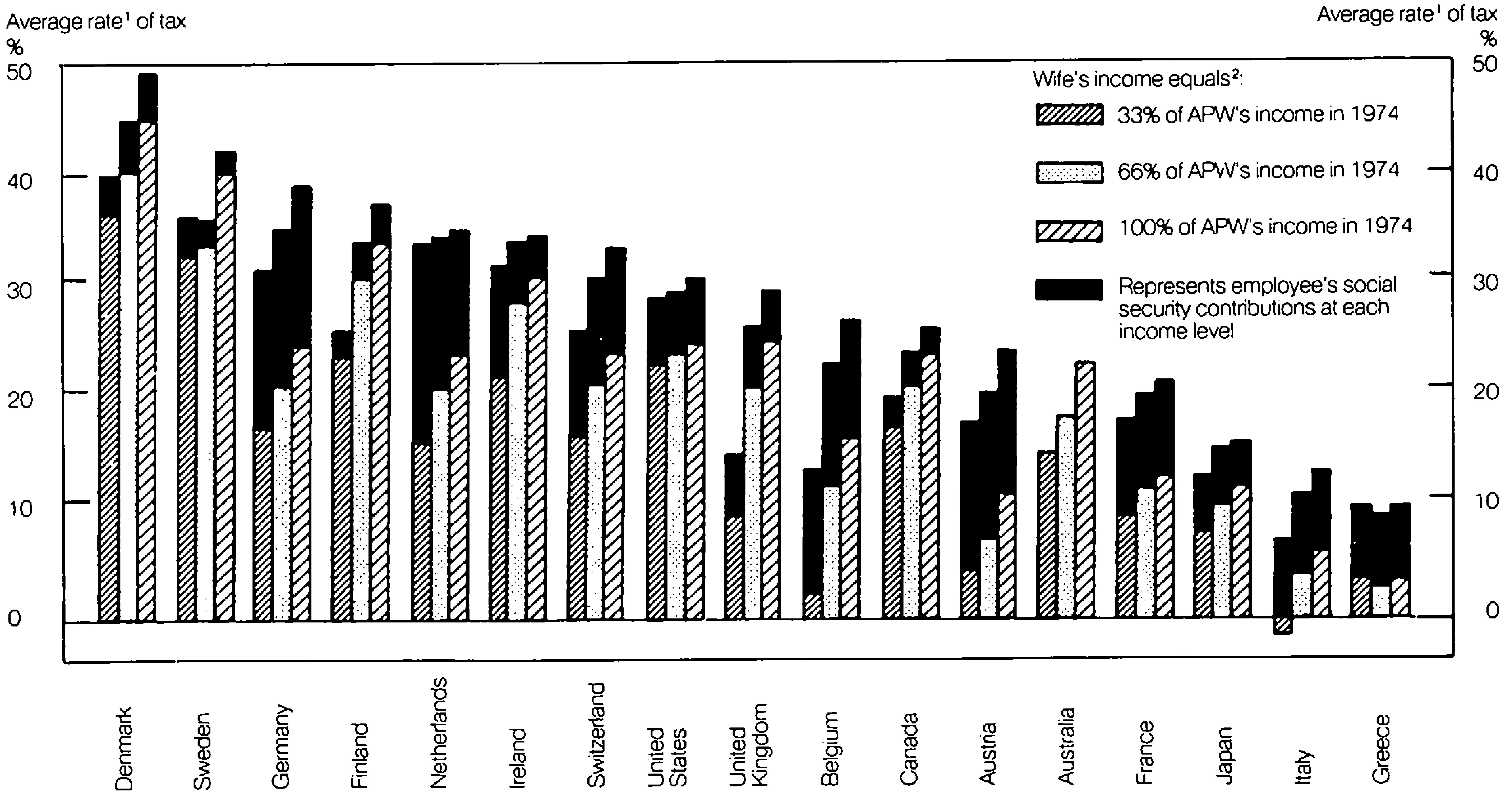
[129] Id., at 30-31.

[130] Id., at 56.

Chart 1
O.E.C.D. countries, 1974:
The working wife's average rate of income tax and social security contributions when she enters the labor market at different gross income levels
Case of a family without children



1. The figures represent the additional income tax and social security contributions paid by the family expressed as a percentage of the wife's gross earnings.
2. In each case the husband earns a wage equal to that of an Average Production Worker (APW).

The low level of tax imposed on the low-earning Belgian wife is attributable to the fact that she is allowed a basic allowance of 40% of her income below certain limits.[131] However, this advantage is largely offset by the high social security contribution she must pay. The Belgian, Italian and Greek low-income wives all pay *more* for social security contributions than in tax, and the low- and high-earning Austrian wife has less liability for tax than social security contributions. Though Sweden and Denmark require a higher overall rate of contribution to the government from working wives (and from taxpayers in general) than the other countries shown, and have comprehensive social security systems, they and Australia, Canada, and Finland designate a much smaller proportion of the government's share of the individual's income as "social security contributions".

The countries shown in Chart I as those where the tax paid by the working wife is lowest at all income levels include those with individual taxation (Austria, Greece, Italy and Japan) and those with family or joint taxation (Belgium and France). The low taxes imposed on working wives reflect the levels of taxation in those countries generally rather than any particular ideology or system.[132]

Another complicating factor that must be taken into account in evaluating the impact of a tax system is that family disposable income can also be affected by cash transfers that are made available either on the basis of status, to all in a specific classification (children, the elderly) or on the basis of need, as demonstrated by a means test (supplementary benefits or rent allowance to low-income persons), and by the taxability of the payments received.

Though the OECD report included only a small portion of the different kinds of cash transfer benefits available in member countries (those associated with marriage, employment of a spouse, and children) it found

> . . . that there are a number of instruments for attaining the desired relative contributions from different family groupings at different income family levels, but that the complexity of their interaction makes it doubtful whether the legislator or public opinion always appreciates clearly the results achieved in practice . . . similar results in terms of after-tax income can be achieved under systems which, at first sight, appear to be based on different principles.[133]

A closer look at the antithetical principles themselves reveals that neither is quite what it has been made out to be or quite as pure as might appear at first sight. The Swedish tax reform of 1970 is claimed to have "established the principle that every individual is independent and should be self-supporting."[134] Since no individual can be independent and self-supporting from birth until death, but only during certain economically "productive" periods in her or his lifespan, what the Swedish system does is to minimize the necessary dependence of one human individual on another in one of the many traditional status relationships that were developed over the centuries to support people during childhood, sickness or age and to transfer dependence directly to the nation as a whole, through government programs.

The Canadian Royal Commission's stirring statement that "the family is today, as it has been for many centuries, the basic economic unit in society" is equally misleading and begs many questions. First, the societal definition of who is included in the family economic unit has undergone radical change.[135] For example, today most people in their declining years look for their major financial and medical support to government programs rather than to their kin, as was customary a hundred years ago. Second, it is much less true today than a hundred years ago that the fact of marriage itself necessarily brings with it the economic dependence of the wife on her husband. Such lack of economic dependence, when it occurs, being usually caused by pregnancy and associated early child care responsibilities, is more circumscribed today, with the availability of conception control mechanisms. Third, it is becoming increasingly apparent that a growing proportion of children in the countries discussed are effectively not directly financially supported by their absent fathers when the marital relationship between their parents has ended. Lastly, as the public discussion in the U.K. about privacy plainly demonstrates, the degree to which even harmonious marriages are integrated financially can vary enormously, and mandatory aggregation of a couple's income for tax purposes can be as inapposite as mandatory individual taxation.

ANALYSIS

Having identified some of the current myths that color or lead to entirely false conclusions as to the optimum tax system from a feminist[136] viewpoint, I will briefly analyze some of the features and look at the net results of the combination of government transfers in operation today in the three countries reviewed.

Both the U.S. and Swedish tax systems are gender neutral on their face, whereas the U.K. still treats taxpayers differently because of the combination of their status, activity, and gender – while the U.S. and Sweden make allowances available to the lower earning spouse, the U.K. gives allowances to married *men,* and different allowances to working *wives.*

In their efforts to counterbalance the disparate impact that the aggregation rules were perceived to have on working wives (in a cultural context which viewed the husband as the primary breadwinner) the U.K. and U.S. added an earned income deduction for the second spouse where both were present and in the workforce. This modification has led to the greater relative disadvantage of single parent households which are increasing in number in both countries and are overwhelmingly headed by women. This modification additionally

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[131] Id., at 26.

[132] Id., at 55-56.

[133] Id., at 9.

[134] *The Economic Situation of Swedish Households* (Fact Sheets on Sweden, 1980).

[135] M. Glendon, *The New Family and the New Property* 47 (1981).

[136] Feminist: a supporter of women's claims to be given rights, opportunities and treatment equal to those of men. *Oxford American Dictionary* (1980).

compounds the disadvantage already suffered in the U.S. by the single parent family unit in that its head already qualifies for a less generous deduction than a married couple. It seems something of an anachronism in the 1980s to grant larger deductions to married couples – as though it were the fact of marital status that disadvantaged people economically, and needed to be compensated for – rather than the fact of parenting minor children.

Both the U.K. and U.S. have social security contribution programs that undermine the progressivity of the tax system[137] and adult personal deductions whose regressive effect is not offset as in Sweden by its gradual disappearance at higher income levels. The U.S. has no child allowance or child benefit payment system as in Sweden and the U.K., only a regressive personal deduction per child. In the U.K. and the U.S. a custodial parent who receives no or inadequate child support payments from the absent parent must fall below a basic subsistence standard of need before becoming eligible for means tested government supplementary income; in Sweden the basic maintenance allowance is paid for each child automatically, without pauperization being a prerequisite.

The net results of these different features in the three systems are shown in Tables 13, 14 and 15. Table 13 shows that in comparable families with a moderate income, the U.S. family retained a larger proportion (76%) of its income after government taxes and transfers than either the U.K. or Swedish family, who kept 73.5% and 72.8% respectively.

Table 14 shows that of all the hypothetical families with combined earnings of $ 10,560 (or the equivalent), the one with the greatest amount of available income after the government transfers was the single Swedish parent with two children; the family with the least amount of available income was the U.S. single parent.

It also shows that whereas there is steep progressivity in Sweden – with the low earning family netting 131% of its gross and the moderate income family netting 72.8% – the U.S. system is the least progressive, in that the low income single parent retains 82.8% of her income, while the family with twice that income retains 76% of its gross. The single parent families with 2 children in both the U.K. and the U.S. retain less net income than the counterpart family with two adults, one earning, and one child and are much worse off than low income families with two earners and the same gross income.

Table 13

Gross and net incomes of moderate income families in the U.K., U.S. and Sweden
(Assuming a two-earner couple with two children, aged 4 and 6)

United Kingdom
H: £6,700 W: £4,800 Total: £11,500

	£
Married man's allowance	2,445
Wife's earned income allowance	1,565
Interest deduction	3,500
Total allowances	7,510
Taxable income	3,990
Taxes at 30%	1,197
NIC	548
Total payments	1,745
Net income	9,755
Less rates[a]	1,800
	7,955
Plus child benefit	494
Available income	8,449
(As percentage of gross	73.5)
Available income after child care cost, £ 790	7,659
(As percentage of gross	66.6)

United States
H: $ 14,740 W: $ 10,500 Total: $ 25,240

			$
Personal exemptions			4,000
Two-earner couple deduction			528
Deductions exceeding ZBA[b]			2,500
Total exemptions and deductions			7,028
Taxable income			18,272
Tax before credits			2,514
CHILD CARE			NO CHILD CARE
Credit	1,695		—
Tax	819		—
Net	24,481		22,786
	1,695	Soc. sec.	1,695
	200	Health ins.	200
	671	State tax	671
	1,000	Real est. tax	1,000
	3,566		3,566
	20,915	Available	19,220
	4,800	Child care	0
	16,115	Available	19,220
	(63.7	% of gross	76.0)

Sweden
H: Skr. 67,000 W: Skr. 48,000 Total: Skr. 115,000
Net available income before child care: Skr. 83,700 (72.8% of gross)
After child care (Skr. 7,900), Skr. 75,800 (66.0% of gross)

a. 100% of rateable value of £ 1,800.

b. Assumes mortgage interest cost of $ 2,000.

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[137] "You get socked with a payroll tax on the very first dollar you earn. But on the part of the income you receive at just over $ 30,000 per year you pay nothing. Result: if you make $ 200 per week – $ 10,000 per year, you pay the same flat percentage of tax on your income as if you make $ 30,000 per year. But if you make $ 100,000 per year you pay less than a third as high a percentage of your income in payroll taxes as if you make $ 10,000! The more you make, the less you pay. W. Proxmire, *U.S. Senator William Proxmire Reports to You from Washington* (Apr. 1983). Until recently some U.K. social security payments were flat rate.

Table 14
Available income[a] as a percentage of gross income of families in the U.K., U.S. and Sweden in the early 1980s[b]

	U.K.	U.S.	Sweden
Gross income[c]	£4,800	$10,560	Skr. 48,000
Percent available to:			
Single parent, two children aged 8 and 10	89.0	82.8	131.0
One-earner couple, one child	84.0	85.2	—[d]
Two-earner couple, one child	96.0	90.2	—[d]
Gross income	£11,500	$25,300	Skr. 115,000
Percent available to:			
Two-earner couple, two children, aged 4 and 6	73.5	76.0	72.8

a. "Available income" is net after taxes, social security and health insurance contributions, cash benefits and state/local taxes (no child-care costs). At the £4,800 income level, the U.K. family would probably qualify for a rebate on any rates paid.
b. The Swedish hypothetical was computed in June, 1980. The U.K. computations are based on 1982-83 tax and contribution rates, the U.S. computations on 1982 rates.
c. In 1980 Skr. 1.00 = $0.22 = £0.10 (approx.), so gross incomes are comparable.
d. Figures unavailable.

Table 15
Amounts available per capita, after taxes and government transfers, to selected families in the U.K., U.S. and Sweden

	U.K.	U.S.	Sweden
A. GROSS INCOME	£ 4,800	$10,560	Skr. 48,000
Single parent of two children, 8 and 10, before child care:	£ 1,421	$ 2,915	Skr. 20,967
Expressed in dollars:	$ 3,127	$ 2,915	$ 4,613
As percent of per-capita income of B family:	67.3	60.6	100.1
Two-earner couple with one child, before child care:	£ 1,530	$ 3,174	—
Expressed in dollars:	$ 3,366	$ 3,174	—
As percent of per-capita income of B family:	75.1	66.0	
B. GROSS INCOME	£11,500	$25,300	Skr. 115,000
Two earner couple with two children, before child care:	£ 2,112	$ 4,805	Skr. 20,925
Expressed in dollars:	$ 4,646	$ 4,805	$ 4,603

Table 15 demonstrates the findings more graphically by showing the differences in per capita available income to the members of the families with different memberships and different incomes.

The Swedish single parent with a gross income of 48,000 Skr., after all government transfers, netted very slightly more for her family per capita, than the Swedish family earning a total of 115,000 Skr., (20,966.7 Skr.to 20,925 Skr.), at the equivalent of $ 4,612.67 per person. The U.K. single parent with the same income netted 67.3% for her family per capita of the income available to the higher earning U.K. couple, at the equivalent of $ 3,126.57 per person. The U.S. single parent fared the worst – both in absolute dollars available per family member – $ 2,914.96 – and in relation to the higher earning U.S. couple. The U.S. lower income single parent's family netted 60.6% per capita of the net income available per capita to the higher earning U.S. couple ($ 2,914.96 compared to $ 4,805).

In Sweden a low income single parent family nets a moderate per capita income. In the U.K. and the U.S. the low income families discussed suffer a net loss after taxes and transfers, the single parent families being the most heavily penalized.

SOME CONCLUSIONS

A rational income transfer policy would integrate what are today viewed as independent if overlapping systems, so that social security contributions or taxes would not undo the work of basic support programs and vice versa, and politicians and people could predict and comprehend their outcomes. All obligations and payments would be indexed for inflation, in order to neutralize the external distortion of the chosen redistributive pattern, and "the introduction of successive concessions which have the effect of constantly shifting the tax burden in a manner which is no less far reaching for being unobtrusive" would be strongly resisted, lest "the tax system, behind a facade of formal equality, metes out unequal treatment to the different classes of the tax paying community."[138]

The income transfer policy would not treat individuals more or less favorably on the basis of their gender, but would be gender-neutral.

The integrated tax system would *mandate* neither individuals nor aggregations as the units for taxation, but would allow persons to opt for aggregational taxation in publicly declared and easily verifiable,[139] socially approved units. Where such socially approved units were perceived as being of value, they would be encouraged by being given tax-favored rather than tax-neutral or tax-penalized status. For example, if a society wished to encourage marriage rather than informal cohabitation it would make marriage a tax-advantaged status yet allow couples who either do not in fact aggregate and share their income as a partnership unit or to whom treatment as a unit would be disadvantageous to opt to be taxed as individuals.

If a rational society wished to enforce financial obliga-

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[138] Royal Commission on the Taxation of Profits and Income, *Final Report, Memorandum of Dissent* (Cmnd 9474, 1955).

[139] "Strong arguments may be put forward for full equality in social security law between married couples and couples living in marriage-like informal unions. The main difficulty is that this involves "quilt-raising" – investigation of matters that are essentially private." I. Pederson, *Non-Marital Relationships in Danish Law,* 28 Int'l & Comp. L.Q. 125.

tions on its members, as with support contributions for the expenses of raising minor children, for instance, it would make the fulfillment of these obligations as streamlined, painless and unevadable as possible.[140] That is, the money would be automatically withheld at source and be tax-deductible.

> If a child is seen as an individual in his own right who is under the temporary incapacity of childhood, there is no room for allowing a person, whether or not the parent of the child, any scope for acting contrary to the child's interests. On the contrary, it becomes the duty of society to protect the child's interests when they are in jeopardy from or in conflict with those of any other person.[141]

It follows, then, that individuals who fulfill the responsibilities of nurturing the young would not be financially or socially penalized for staying with their child-raising undertaking as are so many[142] – mainly women – in the U.K. and the U.S. in the 1980s.

Sweden has demonstrated that Government tax and transfer systems can be designed so that the responsibilities of custodial parenthood after divorce do not entail the pauperization of large numbers of parents who do not abandon their children.

Because age old social institutions were shaped in times when women were considered inferior and dependent entities it does not follow that these institutions must be abolished or abandoned now that women are increasingly recognized as full and equal human beings. Societal institutions can be refashioned to reflect today's philosophy, so that the aggregation of two human beings into the unit of marriage can become a freely entered equal partnership[143] and can be taxed as such.

In the United States over the past ten years there has been a resurgence of interest in a growing number of the forty-two separate property states in the possibility of conversion to the joint and equal management model of community property.[144] In 1983, the influential National Conference of Commissioners on Uniform State Laws approved a Uniform Marital Property Act.

The interest, this second time around,[145] stems not from tax saving considerations, but from attraction to an egalitarian concept of marriage. Each partner, no matter whether contributing to the marriage by working in or out of the home, would jointly share and manage equally all income accruing to the couple, unless it came as a gift or inheritance to only one spouse or unless the couple had affirmatively opted out of the system and chosen to maintain economic independence. If and when a married couple's income is legally "theirs" and not either "his" or "hers", its aggregation for tax unit purposes both makes sense and maintains equity.

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[Continued on page 282]

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[140] ". . . many of the reform proposals which would have to be considered in any comprehensive review of the financial consequences of divorce . . . involve a major shift away from reliance on private law for the enforcement of financial obligations against individuals and toward a system under which social security benefits would be acknowledged as, and indeed become, the primary method of making proper financial provision for broken homes." The Law Commission, *Family Law, the Financial Consequences of Divorce: The Basic Policy, A Discussion Paper* 2 (Law Com. No. 103, Cmnd 8041, 1980). For one such proposal for the U.S., see Garfinkel, supra note 82.

[141] As recently as 1975 the theories that children might be considered either items of "consumption" or as "investments" were reviewed in a serious scholarly article. Bittker, at 1445-1448.

[142] Of course there are many conflicting considerations operative today. Among them is the argument, sometimes heard, that some poor women conceive children out of wedlock deliberately in order to qualify for the benefits of AFDC. In so far as this is an acknowledgment that there are no more attractive means of earning a livelihood available to them than caring for dependent children 24 hours a day, seven days a week on subsistence payments, there may possibly be some truth to the argument. The solution, however, if this were the case, would more logically lie in making sufficient paid jobs available that the poor could support themselves through 40 hours of gainful employment each week than that they be forced to breed (when they would otherwise not have chosen parenthood) in order to be eligible for subsistence income.

[143] Since the early 1970s all community property systems in the U.S. have been changed so that the management of assets is the joint responsibility of wife and husband.

[144] In 1984 the Wisconsin legislature enacted a system that closely tracks the Uniform Marital Property Act. The new marital property system becomes effective January 1986.

[145] The first occasion on which there was widespread interest in conversion to a community property system is discussed in this study under the "United States: Married Women".

THE EC COMMISSION ON INCOME TAXATION AND EQUAL TREATMENT FOR MEN AND WOMEN

Memorandum of 14 December 1984 presented to the EC Council (COM (84) 695 final)

I. INTRODUCTION AND HISTORICAL BACKGROUND

During the past two decades the Community has taken a number of steps to ensure equal pay and equal treatment for men and women.

Three Directives have been issued by the Council of the European Communities, covering equal pay (75/117/EEC),[1] equal treatment in access to employment, vocational training and promotion, and working conditions (76/207/EEC)[2] and the progressive implementation of the principle of equal treatment for men and women in matters of social security (79/7/EEC).[3]

As a result of their evaluation of these achievements, the European Parliament issued a Resolution on 11 February 1981,[4] making demands on the Community institutions to intensify and broaden Community activity in this area, and, on the question at issue, called on the Commission to present a proposal for a Directive on equal treatment for men and women in tax legislation.

This Resolution prompted the Commission to draw up its New Community Action Programme on the promotion of equal opportunities for women to cover the years 1982-1985,[5] listing a series of specific actions to be undertaken at Community and national level in order to assist in the achievement of equal treatment primarily by making progress towards individual rights.

The Action Programme was subsequently the subject of the Council Resolution of 12 July 1982 on the promotion of equal opportunities for women,[6] in which the Council expressed the will to implement appropriate measures to achieve the objectives of the Action Programme.

Action 6 of the New Community Action Programme was drawn up to focus the Community's attention on correcting the effects of fiscal legislation on equal treatment in working life, particularly in so far as existing systems in Member States might be the cause of indirect discrimination against women. The stated aim of Action 6 is to implement the principle of equal treatment by revising income tax systems which appear to have an indirect adverse effect on women's employment, their right to work and their promotion in employment.

The Commission's task was to undertake a comparative analysis of taxation systems and, if it emerged that these systems had any directly or indirectly negative effect on equal opportunities for women, to take such appropriate measures as were within its competence in this area.

The work was begun by the commissioning of a study into the "Implementation of equal treatment by revising income tax systems which appear to have an indirect adverse effect on women's employment, their right to work and their promotion in employment", which analysed taxation on earned income throughout the Community.[7]

Work has also been undertaken in this area by the European Parliament's Committee of Enquiry into the situation of women in Europe. Its report "Taxation: special problems encountered by women" reached substantially the same conclusions as the analysis conducted by the Commission and stated its opinion that taxation systems should be neutral as regards their effect on women's work.

This report was one of the 18 reports from the Committee of Enquiry presented to the European Parliament together with a Resolution on the Situation of Women in the European Community, which was adopted on 17.1.1984.[8] The 1984 Resolution calls upon the Commission to take note of the Committee of Enquiry's Report on Taxation and its conclusions and to prepare a "Directive on equal treatment for men and women in fiscal legislation".

II. PRESENT SITUATION

The proportion of women working in the European Community has been increasing – from 33.5% in 1970 to 37.5% in 1982, and this in a period where men's activity rates have remained static. This increase would seem largely due to the increased participation of married women and mothers, and the rise in single parent families, which coupled with an economic crisis has meant that more and more women not only want but need employment.

These changes in employment patterns also demonstrate the need for change in other areas that affect employment in order to take account of a changing situation. Income tax systems that were set up with the intention of benefiting the traditional family (i.e. husband working, wife at home or earning pin-money, and with dependant children), entail in present circumstances a very heavy marginal taxation of the family's second income earner, and will, in many situations, serve as a strong disincentive for the wife to join the labour market.

As stated in the previous chapter, the European Community has already adopted three Directives in the field of equality for men and women, which have the effect amongst other things, of promoting women's economic independence. With respect to the subject matter of these Directives, direct and indirect discrimination based on sex or marital status is outlawed, with the aim ensuring that women and men receive equal pay and equal treatment in employment and social security. A situation where the tax treatment of working women differs, in practice, from that of men, runs counter the progress already achieved in promoting equality in employment, and may in cases where a women finds her tax payments increasing upon marriage, act as a disincentive in her decisions relating to employment.

It is not only with regard to wage-earners that obstacles can arise to the application of equal treatment in practice. A particular problem affecting a number of women in the Community is that of tax which have a restrictive effect on remuneration for the work done by the spouse of the head of a business. Wages paid to a spouse are generally deductible from the taxable income of the head of the business only up to a certain ceiling, which inevitably limits the actual amount paid to that ceiling.

The Commission has made its position clear on this subject in its proposal for a Council Directive on equal treatment for men and women in self-employed occupations, including agriculture, and on protection during pregnancy and maternity[9], submitted to the Council on 15th March 1984. Articles 6 of this proposal states that "Member States shall take the measures necessary to abolish fiscal provisions and practices which constitute direct or indirect discrimination in that they prejudice in a substantive way the status of the spouse as employee."

III. DESCRIPTION OF EXISTING INCOME TAX SYSTEMS

Income tax is calculated with reference to a basic structure consisting first of all of the tax unit or taxable person concerned. Once that unit has been identified, the amount of income which will be taxed must then be calculated, by reference to income earned, less allowances permitted by the system in question. Upon that taxable income, certain rates of tax are then applied, producing the tax payable, an amount against which under some systems tax reductions may be offset.

It must be stressed that this Memorandum is concerned with income earned from employment, and not with the taxation of unearned income. It is also relevant to mention at this juncture that some of the more complex problems concerning the taxation of couples also concern the risk of discrimi-

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1. OJ No. L 45, 19.2.1975, p. 19.
2. OJ No. L 39, 14.2.1976, p. 40.
3. OJ No. L 6, 10.1.1979, p. 24.
4. OJ No. C 50, 9.3.1981.
5. COM (81) 758 final.
6. OJ No. 186 of 21.7.1982, p. 3.
7. V/2798/1/83 final.
8. Doc. 1-1229/83/C.
9. COM (84) 57 final.

nation between married and unmarried persons as well as the differences in treatment of the first and the second earner. Moreover, it must also be born in mind that each national system of taxation has been developed as an entity with a coherent balance between units, rates and allowances; a change in any of these elements may require other adjustments to maintain a balance in the system.

A. Tax unit

In the Member States of the European Community different forms of the two basic types of tax unit can be found, these two basic types being the household or the individual.

Taking first the systems that use the household as the tax unit, the most basic form of this is aggregate taxation pure and simple. Under this system the incomes of spouses are added together to determine the amount of taxable income.

After permitted deductions have been made, the tax rate(s) is applied to the total remaining income.

If we then look at this situation from the point of view of two people before and after marriage, we can see the effect of aggregate taxation when combined with a set of progressive tax rates.

Example 1

Pure aggregation A earns 10,000 ECUS
B earns 5,000 ECUS
Hypothetical tax rates: 30% on first 5,000
40% between 5,000 and 10,000
50% between 10,000 and 15,000
As single people A pays 30% on 5,000
40% on next 5,000
= 3,500 ECUS
B pays 30% on 5,000
= 1,500 ECUS
Both together pay 5,000 ECUS.

As married couple

Husband is in general responsible for payment on their total income of 15,000 ECUS.

Couple pay 30% on 5,000 = 1,500 ECUS
40% on next 5,000 = 2,000 ECUS
50% on next 5,000 = 2,500 ECUS
a total of 6,000 ECUS

In other words, the couple may consider that in practical terms, upon marriage, B's earnings of 5,000 ECUS are now liable for 2,500 ECUS in tax rather than the 1,500 ECUS paid before.

This is of course a simplistic example, taking no account of other tax advantages that might be accorded to the couple in the way of allowances, tax reductions, etc; it can, however, be said that the nature of the system is such as to discourage the lower earner of a couple, be that the wife or the husband.

Recognition of this problem has led to the institution of forms of aggregate taxation which take into account the problems of applying progressive tax rates, in so far as a couple's earnings are concerned, the most widespread of these being the splitting system. Under this system the earnings of the spouses are added together then divided in two. Even where only one spouse has an earned income, this will still be divided in two. The tax is then multiplied by two to produce the total amount of tax due. The splitting system makes an attempt to take the different contributive capacity of couples into account and to minimise difference between one and two earner couples.

Example 2
splitting system, taking the same hypothetical tax rates as example 1)

A earns 10,000 ECUS
B earns 5,000 ECUS

As single people

A pays 3,500 ECUS
B pays 1,500 ECUS

As married couple

Household pays tax
on 15,000 : 2 = 7,500 ECUS
at 30% on 5,000 = 1,500 ECUS
at 40% on 2,500 = 1,000 ECUS

As married couple

Household pays tax on 15,000 : 2 = 7,500 ECUS
at 30% on 5,000 = 1,500 ECUS
at 40% on 2,500 = 1,000 ECUS

This total of 2,500 ECUS is then multiplied by 2 to give tax due of 5,000 ECUS, the same joint total as they would have paid as single people.

The most important effect, however, of the splitting system is that income is split regardless of whether one or both spouses are contributing to it.

Supposing therefore that A, our higher earner, is also be sole earner for the couple, we can see a difference in tax payment under the splitting system by simple virtue of being married. As a single person A would have paid 3,500 ECUS on the supposed 10,000 ECUS income, under the aggregate system 3,500 ECUS also, but under splitting only 3,000 ECUS would be payable.

A variant of the splitting system is found in the system of family quotient, whereby the aggregate income of the family, spouses and dependent children, is divided by a "family quotient" rather than simply by two. This "quotient" is calculated by reference to the number of persons comprising the family unit, increasing by a certain proportion according to the number of dependants within the unit. The tax is calculated on the family income divided by the quotient, then the amount of tax obtained is multiplied by the quotient to produce the total tax due.

Within the aggregate system, some relief may also be given by the use of very wide tax bands or double tax bands which limit the progressive nature of the rates applied.

The second form of tax unit employed is of course the individual, where each person is taxed on his/her own income, as single people, although allowances etc. may differ with the family situation of the individual concerned. This is known as separate taxation.

This should not be confused with systems of "separate assessment", which come within the aggregate taxation system. Under "system assessment" total tax payable does not change, cut is attributed to each spouse according to income.

Income tax systems applied
in the Member States[10]

Belgium	: Aggregation (variations of splitting and separate taxation)
Denmark	: Separate taxation
Germany	: Splitting (may choose separate taxation)
France	: Family quotient (variant of splitting)
Greece	: Separate taxation
Ireland	: In principle, separate taxation, in practice, aggregation used
Italy	: Separate taxation
Luxembourg	: Aggregation (plus splitting or family quotient)
Netherlands	: Aggregation, with separate assessment
United Kingdom	: Aggregation or separate taxation

B. Tax rates

Equal tax treatment of men and women can be assumed to imply that the fact that an income is earned by a man or by a woman should not affect the rate applied. Under a system of separate taxation this would necessarily be the case. Under the aggregate system in its basic form this can only be the case if a single tax rate is applied. In the European Community, however, progressive tax rates are the norm. Their effect is minimised by a variety of systems; more or less effective, depending on the incomes earned.

These systems have been described under "A" as being the splitting system, the family quotient system, and systems which try to ensure that the progression of rates ascends in wide bands (United Kingdom) or where tax bands are doubled for couples (Ireland).

When it comes, therefore, to the systems which offer a choice to the individual to opt for a system of separate taxation, the choice is affected first of all by the different rate structure. If separate taxation means avoiding progressive rates it will be the favoured option. In order cases where the aggregate system provides compensation for progressive rate structures by splitting or other methods, the financial advantage of opting for separate taxation will depend on income.

C. Tax allowances and reductions[11]

There are a bewildering variety of methods for taking a taxpayer's family and personal

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[10] Information given is taken from the study on income tax systems, completed in 1982, and updated where information has been available. Footnote 1, p. 2.

[11] *Definition* – allowances: amounts which can be deducted from taxable income before tax;
– reductions: once tax is calculated, amount by which tax payable is reduced.

circumstances into account in the calculation of tax liability.

Such allowances and reductions are mostly of benefit to the spouse who earns the higher income, although not invariably, as the method of calculation (flat-rate or percentage) may have different effects according to the levels of income earned by each spouse. Some Member States have preferred, in the case of allowances granted for the benefit of children, to pay an allowance directly to the person who is responsible for the care of the child, thereby avoiding any reference to the ordinarily taxable income of either spouse (system used in Denmark, F.R. of Germany, Netherlands and United Kingdom), as well as, in some cases, providing for an allowance against tax.

Tax relief in general seems to fall into certain groups where, as a matter of national policy, certain expenses incurred by taxpayers may be deducted either from their income before tax, or from the tax to be paid upon their income.

The most generally accepted criteria for personal allowances include:

- dependent children (sometimes a separate allowance is granted to the person caring for the child)
- other dependants, often on stringent conditions
- on marriage, some Member States grant a type of premium upon marriage
- child care expenses, in some Member States
- tax relief for repayment of mortgages or insurance premiums.

Clearly the right to deduct allowances from income liable to tax or deductions from taxes payable directly affects the tax due from each individual. It is interesting to note that where the Member State offers a choice between an aggregate or a separate taxation system, it is the difference in allowances as well as the rate structure available under each system that determines the choice. For instance some allowances are still granted only to the husband, and the choice of separate taxation can entail a loss of allowances.

Even in those States where a tax reduction is granted specifically on the earned income of the wife, this does not reflect the real additional charges on her income, particularly as less than half the Member States allow the declaration of expenses for child-care and upkeep of the home to either the husband or the wife. The ability to deduct the necessarily increased expenditure involved in caring for children and domestic work in a household where both spouses work outside the home, would help to offset, particularly, the impact of progressive rate structures.

D. Tax returns

Tax responsibility for completing and returning a declaration of taxes varies largely according to the tax system employed, in the sense that in general under the system of separate taxation, each taxable person files his/her own tax return, although in Greece husband and wife make a joint declaration, which the wife signs also only if she has in-

Allowances and reductions[12]

	Dependants	Child-care expenses	On marriage	Personal
Belgium	Tax reductions for dependent children, spouse (under aggregation)		Tax reduction for husband on first marriage, first child	Flat-rate basic allowance divided according to income. Extra allowance for lower earner of couple
Denmark				Flat-rate allowance doubled if only one spouse has income
Germany	Allowance for dependent children under certain circumstances			
Greece	Allowance for wife even if she has own income. Allowance for dependent children. Also reductions	Cost of nursery deductible if wife has prof. activity		Flat-rate personal allowance
France	Dealt with in family quotient system	Allowance for child care etc. where both spouses work		Flat-rate deduction for each wage-earner
Ireland	Allowance for dependent children	Housekeeper allowance for heads of one-parent families	Nuptial allowance in first year of marriage	Flat-rate personal allowance
Italy	Reduction for spouse with income less than a certain amount. Reduction per child, and other dependants			Flat-rate reduction
Luxembourg		Flat-rate allowance for domestic staff or child-care		Flat-rate allowance
Netherlands		Allowance for child-care expenses (new law)		Flat-rate allowance
United Kingdom	Same allowances	Allowance for single parents with child/children living at home	Married man's allowance	Flat-rate personal allowance

12. See footnote 1.

Responsibility for filing a tax return – married couples

	Husband	Wife
Belgium	must file	must file (same form)
Denmark	must file	must file
Germany	splitting – must sign joint return – separate taxation– files own return	splitting – must sign joint return – separate taxation – files own return
Greece	files joint return, husband must sign	joint return, signs only if she has income
France	must sign joint return	must sign joint return
Ireland	files joint return. May do so even if wife has sole income	may file return if taxed or assessed separately
Italy	must file return (may file jointly)	must file return (may file jointly)
Luxembourg	"tax-payer" files joint return	
Netherlands	return filed if receives income	return filed if receives income
United Kingdom	aggregation – responsible for filing return. separate taxation – may file separate return	separate taxation – may file separate return

come of her own. In Italy a married couple may file a joint return if they wish.

Under the aggregation systems in general married couples file a joint return, for example in Germany under the splitting system, in France, in Ireland, in Luxembourg and in the United Kingdom. In Belgium each tax-payer should file a return, but married couples use the same form. Some tax systems require the signature of both partners (Germany) for others the husband must sign it (United Kingdom, Ireland). In France, under 1983 legislation, both partners must now sign the return, where previously the wife might sign if she earned her own income.

IV. PROBLEMS RELATING TO EQUAL TREATMENT WITH REGARD TO EXISTING SYSTEMS

A recent survey[13] was undertaken into discrimination against women at work in the 10 Member States.
One of the questions put was as follows:

- some people say that the way income tax works in your country makes it, in certain families, hardly worthwhile for the wife to work because too much of what she earns is taken away in tax from her or her husband's salary.

It was interesting to note that the highest percentages of women who felt the tax system did dissuade married women from working came from Ireland, Luxembourg and Belgium, where aggregate taxation is the rule. The lowest percentages came from Italy and Greece, where separate taxation is applied.

It would, at a time when the number of married women on the labour market is increasing, be difficult to assess the precise role played by systems of taxation in married women's decisions to work or not. It can, however, be said that when analysing income tax systems from the point of view of their impact upon married women, a difference in treatment can be found under many systems.

This difference in treatment could not necessarily be described as direct discrimination, as often it is only indirectly that the tax system in fact affects married women. Taking the most obvious case of aggregate taxation, we can see from Examples 1 and 2 above that, for the couple, the wages of the lower earner will be considered to be the secondary income and will be taken as being taxed at the highest rate applied. In the category of lower earners, we will find the majority of married women, who do indeed often perceive their treatment as being discriminatory.

The combination of reduction in the income accruing from the women's earnings outside the home and a corresponding increase in the value of her work in the home upon marriage and the birth of children may together have a real effect on her view of the economic value of employment, while the married man in general would consider that he receives tax benefits upon marriage and upon the birth of children.

It can of course be said that the reverse of this situation is true when the husband is the lower earner of the couple, a situation, as mentioned above, which arises in a minority of cases. We are not here dealing with a case of direct discrimination, but one where an indirect adverse effect is created by the use of a system which in practice differentiates in its treatment of women and men when taken as a couple for tax purposes.

One can assume that the various systems of income taxation in the Member States are not the result of an intention to discriminate against women, but of historical fact, that women were regarded as economically dependent upon their husbands, in whose name property was held and income received. This traditional concept of the one earner family with dependent children is, however, no longer the norm. Taking the situation, for example, in the United Kingdom, the married man with a non-working wife and dependent children represented in 1979 8% of the male labour force and 5% of the total labour force.[14] During the last ten years a number of Member States have, as a consequence, introduced measures aimed at reducing the effect of progressivity on the family income.

Where the effects of pure aggregation have been diminished by the use of a splitting or family quotient system, some comments need to be made on these systems from the point of view of a married woman.

Marriage and the splitting system operate most in favour of high income one-earner families, as the income is split regardless of the number of persons contributing to it, and there can thus be a strong incentive in these families to keeping the woman in the home, on the basis that the marriage is already contributing money in reduced taxation and any income the wife earns will again start being taxed at the highest rate paid by the husband and be the less useful for the household.

Taking our Example 2 above, we have seen that the couple pays 5,000 ECUS in tax whether single or married. Assuming then, that our higher earner A is the husband. He will see a lessening in taxation on his income by virtue of marriage, as his tax will be reduced from 3,500 ECUS to 3,000. Inevitably the couple will in this case view B's tax as representing the 2,000 ECUS remaining in the total of 5,000 ECUS payable on their joint earnings.

Couples may be concerned with their total tax burden. In many cases their total taxation is not necessarily higher – and may indeed be lower – than under the system of independent taxation, depending on the progressivity of the system. But, that said, in order to achieve equal treatment of men and women a system of independent taxation has obvious advantages. It avoids any aggregation of income, (in some cases of course this may be financially disadvantageous compared to a splitting system) and therefore can avoid a difference in tax rates applied. In systems where it is public policy to assist families by the use of favourable tax systems, there is no reason why allowances and deductions of this kind cannot be part of a system of independent taxation.

Indeed, the continuing increase in the number of married women entering the job market, and the consequent rise in the number of two earner families, coupled with the continued application of tax systems which benefit the traditional family, produces the anomalous situation in some Member States that a growing number of couples will be financially better off remaining unmarried, and this particularly where there are children, owing to benefits granted for one parent families.

It must be added that, whatever the tax unit employed, the allowances and reductions within the system will affect, particularly, choices to be made in countries where taxpayers have the possibility of opting for a system of separate taxation. In practice it appears that few taxpayers opt for systems of separate taxation as opposed to some form of aggregation, where the systems permit a choice. An examination of the options will show that it is often the allowances or reductions available under the different systems that influence choice, as often separate taxation can involve a loss of allowances.

Some allowances remain, granted only to the husband under the aggregation system, (as for example marriage allowances in Belgium and Ireland and the married man's allowance in the United Kingdom).

While it is difficult to assess the precise effect the taxation systems may have upon an individual married woman's decision to work or not to work, the analysis conducted by the Commission clearly demonstrates a very different picture in terms of tax payments by a married woman according to the tax system employed.

Comparing the tax paid by a married woman as against a single woman, leaving aside other possible advantages granted to the couple as a whole, the results of the analysis are clear. From the individual point of view, under separate taxation she pays the same tax, under aggregate taxation she pays more. The splitting system has an effect that is less clear, but in general if the

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[13] European women in paid employment 1984 (V/1240/84-FR).

[14] Final report of the Study Commission "Families in the future", January 1983.

married woman is earning the same amount as her husband she will pay the same tax as a single person. If however she is earning less (which will generally be the case) the couple will pay less tax than an unmarried couple would have paid, but within the couple, assuming that the wife's income is regarded as a secondary income, she will be paying more than a single person and her husband less.

Within the couple one can then compare the situation of a married woman against a married man. Under separate taxation the tax paid should essentially be the same, although under cerain circumstances the married woman may pay less tax (in Belgium, as personal and real property will be added as husband's income and taxed in his name) or more tax (in the Netherlands, as the husband benefits from more exemptions).

Under the aggregation system the income of the lower earner, most often the wife, will in practice be taxed more highly as the income, which is treated as a secondary income, will start paying tax at the highest rate paid by the first income.

It is worth noting that more than one Member State has put the tax unit under study recently and that the results have been varied (in France, recommendations in favour of an option for separate taxation,[15] in the Netherlands an amendment of the tax system which extends equality of treatment for married women, and at the same time assesses individuals separately under a "household" umbrella whatever the composition of the household). In the Federal Republic of Germany an assessment of the splitting system was undertaken and some amendments are envisaged particularly with reference to family allowances. In the United Kingdom a series of bodies have also recommended the abolition of the married man's allowance.

V. PRINCIPAL AREAS FOR CORRECTIVE ACTION

The New Community Action Programme for the Promotion of Equal Opportunities for Women, the opinion of the Advisory Committee on Equal Opportunities and the 1984 Resolution of the European Parliament on the situation of women in Europe have asked the Commission to examine the current situation with respect to the impact of income tax systems on women's work and to proceed to recommend a system with a "neutral effect" on women's work.

It is clear from the foregoing chapters that the system with the most neutral effect from the point of view of equal treatment of men and women workers is that of separate taxation in that the fact of being a married woman does not of itself alter the tax paid by an individual. The effects of progressivity on the tax systems may nevertheless be alleviated under the splitting or family quotient system. Under existing systems of separate taxation a married woman may of course pay more or less tax than her husband owing to the distribution of allowances within the couple, but she will pay the same tax as a single woman.

Equality is seen to be best served when personal allowances and tax reductions may be equally divided between the husband and wife. It is interesting to note that the types of allowances and reductions remain roughly similar under the different taxation systems.

The principal areas within which the impact of the present income tax systems would appear to have an adverse effect upon married women's tax burdens, are the following:

- the system of pure aggregate taxation in general
- systems of allowances or tax reductions granted a priori to the husband
- the lack of an allowance or deduction for the costs incurred in child-care and domestic help when a married couple both work outside the home
- the inability to declare own income for tax
- the responsibility for the non-payment of tax by the other spouse
- limitations on the amount of income that can be paid to an "assisting wife" by a husband, either by the imposing income limits or ceilings for tax exemptions.

A system of totally independent taxation is to be recommended from the point of view of achieving equal treatment and thus at least an option of separate taxation should be available to couples. Since many Member States have recently put income taxation on their internal agendas at least for debate, it would seem a suitable moment for the Commission to remind the Member States of the Community's commitments to equal treatment.

Action 6 of the New Community Action Programme on the Promotion of Equal Opportunities for Women states as its aim the need to revise income tax systems which have an indirect adverse effect on women's employment. The analysis conducted by the Commission in accordance with the Action Programme, concluded that neutrality towards working married women was best achieved under systems of separate taxation, a conclusion demonstrated clearly in graphs and tables.[16]

The Commission has therefore, under the provisions of the Action Programme, a commitment to take appropriate measures. As a first step, this Memorandum should serve to raise these issues for discussion at Community level, and encourage debate on an issue of particular importance for women and for the family as a whole.

It is therefore appropriate that this commitment be followed up by a debate at Community level on the impact of income taxation systems on equal treatment of men and women in the labour market. Such a debate which could draw on the experience of differing taxation systems within Member States should serve to clarify the issues involved with a view to stimulating a more detailed review within the Member States of current provisions.

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[15] Cf. in particular Social and Economic Committee report.

[16] See study on "Implementation of equal treatment by revising income tax systems which appear to have an indirect adverse effect on women's employment, their right to work and their promotion in employment", V/2798/1/82.

Reciprocal Exemption:
A Regime to Treasure

By Tony Kelly

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When as a result of policy changes in the United States, airlines formerly known for their domestic operations began to operate abroad, they surely encountered many problems related to the strange foreign environment. However, one matter which was not a major problem was foreign taxes. As a result of the highly developed regime of reciprocal exemption already in place, not only did they not have to pay foreign income and other taxes, but even more importantly perhaps, they did not have to file returns involving translations of their published accounts into foreign languages and recasting their bookkeeping into foreign accounting systems.

The first U.S. tax treaty containing reciprocal exemption was executed in 1940 and in the intervening 44 years such a clause was contained in every single United States treaty, with one notable exception (see below).

Apart from U.S. treaty policy, reciprocal exemption has been adopted by the Organisation for Economic Cooperation and Development (OECD) in its 1963 Model Draft Double Taxation Convention[1] and later also in its 1977 Model Double Taxation Convention. This model was adopted for the very reason that it avoids the double taxation to which airlines are particularly exposed by the very nature of their business. The OECD model conventions are the starting point for most treaty negotiations world-wide and, as a member, the United States has consistently followed the OECD approach.

Similarly, the Council of the International Civil Aviation Organisation (ICAO) adopted in 1966, with U.S. support, a resolution requesting each Contracting State to grant reciprocal exemption from taxation on the income of air transport enterprises.

In its own "model" tax treaty, released by the Treasury Department on 17 May 1977, the U.S. reaffirmed its position with an article which re-echoes the OECD model.

We note both from ICAO and the surveys conducted by IATA that the vast majority of bilateral air transport relations are governed by the principles of reciprocal exemption of taxes on income. Most countries also exempt taxation on expenditure for products used in international air transport.

This philosophy, which was originally developed for shipping, was inherited and refined for air transport over the last sixty years. The 1966 ICAO resolution comprises, in fact, four different resolutions covering income taxes, fuel taxes and sales or use taxes.

Let us concentrate firstly on income taxes. To demonstrate the effects of multilateral reciprocal exemption, in Example I we have 5 countries with 5 airlines with no exemptions, i.e. each country taxing each airline. It is assumed that the airlines pay 600 tax in their home country and 100 tax in the other countries. While this is a limited example, you can imagine the burden on an international airline serving, say, eighty tax jurisdictions in just filing the necessary papers. The figures in italics are a notional cost of tax filing. Luckily enough, because we inherited multilateral reciprocal exemption, the industry has never had to face such a nightmare.

EXAMPLE I

	Countries					
	AAA	BBB	CCC	DDD	FFF	Total
Airline A	600	100	100	100	100	1,000
	100	*10*	*10*	*10*	*10*	*140*
Airline B	100	600	100	100	100	1,000
	10	*100*	*10*	*10*	*10*	*140*
Airline C	100	100	600	100	100	1,000
	10	*10*	*100*	*10*	*10*	*140*
Airline D	100	100	100	600	100	1,000
	10	*10*	*10*	*100*	*10*	*140*
Airline F	100	100	100	100	600	1,000
	10	*10*	*10*	*10*	*100*	*140*
Total	1,000	1,000	1,000	1,000	1,000	5,000
	140	*140*	*140*	*140*	*140*	*700*

The situation up to the late 1970s is more reflected in Example II.[2] In this case each airline only files and pays

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[1] Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated. OECD Model/Draft Convention for the avoidance of double taxation on income and capital, Art. 8 para. 1.

[2] The reason for the change from 1,000 to 900 between Examples 1 and 2 is that it is not always possible to get tax credits in the home country for taxes paid abroad. Therefore, paying in multiple jurisdictions will usually work out more expensive.

taxes in its home country or state of registration. According to the theory, because of balancing tax credits, the airlines will effectively pay the same amount of taxation but will save the not insignificant cost of filing in the different jurisdictions. In this example, the saving is understated because, again, we are only looking at a limited number of countries. Also, there is a saving in tax paid because the different tax philosophies do not always lend themselves to offsetting taxes paid abroad with a tax credit in the home country. So the system we have been enjoying for the last fifty years or so has been of considerable advantage to the industry.

EXAMPLE II

Countries

	AAA	BBB	CCC	DDD	FFF	Total
Airline A	900 *100*					900 *100*
Airline B		900 *100*				900 *100*
Airline C			900 *100*			900 *100*
Airline D				900 *100*		900 *100*
Airline F					900 *100*	900 *100*
Total	900 *100*	900 *100*	900 *100*	900 *100*	900 *100*	4,500 *500*

Needless to say, given the current political and economic environment, it would be unthinkable to try and develop from scratch such a system today. There are, unfortunately, a number of exceptional cases such as the Philippines, which has not accepted the principle of reciprocal exemption for air transport; but these are exceptions.

What we have been facing in the last decade is the problem caused by an attempt, particularly within certain federal states, for internal taxing jurisdictions to tax international air transport. While the most significant problems in the area have been in the United States and Canada, it should be pointed out that, already in the 1970s, similar situations arose in other countries, for example Japan and Italy where municipal authorities took action to tax foreign international airlines. Following action by the IATA Taxation Sub-Committee, most of these attempts failed.

Example III introduces into one of the countries two subordinate tax jurisdictions who assess taxes on the airlines of the other countries. It is evident that the airlines from the other countries are at a disadvantage. It has been argued that this disadvantage is theoretical rather than real.

To show how real it is, we have allowed in Example IV one of the other countries to allow a subordinate jurisdiction to apply taxation to the foreign airlines. Naturally, given the "most favored nation" or nondiscrimination clauses, this country cannot just tax the airlines of the other offending nation (retaliation) but must tax all airlines indiscriminately. As each country reacts, we arrive back, in Example V, at a picture similar, if not worse, than our first example where no reciprocal exemption applied.

EXAMPLE III

Countries

	AAA	BBB	CCC	DDD	FFF			Total
						f1	f2	
Airline A	900 *100*					20 *10*	20 *10*	940 *120*
Airline B		900 *100*				20 *10*	20 *10*	940 *120*
Airline C			900 *100*			20 *10*	20 *10*	940 *120*
Airline D				900 *100*		20 *10*	20 *10*	940 *120*
Airline F					900 *100*			900 *100*
Total	900 *100*	900 *100*	900 *100*	900 *100*	900 *100*	80 *40*	80 *40*	4,660 *580*

EXAMPLE IV

Countries

	AAA	BBB		CCC	DDD	FFF			Total
			b1				f1	f2	
Airline A	900 *100*		20 *10*				20 *10*	20 *10*	960 *130*
Airline B		900 *100*					20 *10*	20 *10*	940 *120*
Airline C			20 *10*	900 *100*			20 *10*	20 *10*	960 *130*
Airline D			20 *10*		900 *100*		20 *10*	20 *10*	960 *130*
Airline F			20 *10*			900 *100*			920 *110*
Total	900 *100*	900 *100*	80 *40*	900 *100*	900 *100*	900 *100*	80 *40*	80 *40*	4,740 *620*

EXAMPLE V

Countries

	AAA		BBB		CCC		DDD		FFF			Total
		a1		b1		c1		d1		f1	f2	
Airline A	900 *100*			20 *10*		20 *10*		20 *10*		20 *10*	20 *10*	1,000 *150*
Airline B		20 *10*	900 *100*			20 *10*		20 *10*		20 *10*	20 *10*	1,000 *150*
Airline C		20 *10*		20 *10*	900 *100*			20 *10*		20 *10*	20 *10*	1,000 *150*
Airline D		20 *10*		20 *10*		20 *10*	900 *100*			20 *10*	20 *10*	1,000 *150*
Airline F		20 *10*		20 *10*		20 *10*		20 *10*	900 *100*			980 *140*
Total	900 *100*	80 *40*	900 *100*	80 *40*	900 *100*	80 *40*	900 *100*	80 *40*	900 *100*	80 *40*	80 *40*	4,980 *740*

It should be noted that one of the original and strongest arguments in favor of reciprocal exemption was related to the operational aspect of applying taxation to international airlines. Almost all authorities have recognized the difficulty of allocating income to one tax jurisdiction on other than an arbitrary basis. A major portion of the distance flown by international airlines is outside the jurisdiction of the country seeking to impose the tax and therefore it is questionable whether the country has the right to impose tax on revenue earned outside its jurisdiction. The operations of an airline into and out of one port in its global network has an economic effect on its operations in every other port of its network and vice versa.

In the Supreme Court case of Japan Line Ltd., et al. v. County of Los Angeles et al. in April 1979, Mr. Justice Blackmun said "Even 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."

We would even argue, and we think our theoretical example shows, that the system of reciprocal exemption can be justified solely on the basis of eliminating the cost burden of the multiple filings.

We have been mainly discussing reciprocal exemption related to income tax. However, we would also like to air our argument with respect to the elimination of sales and use taxes on products used in international air transport. This is also covered in the ICAO Resolutions. We maintain that products such as fuel, in-flight food, spare parts, etc. which are consumed outside of the taxing jurisdictions, or to use the traditional term related to shipping "on the high seas", should not be the subject of domestic taxation. This principle is upheld and applied by the vast majority of taxing jurisdictions.

To sum up, there are distinct advantages to international air transport in maintaining a regime of multilateral reciprocal exemption in that it eliminates burdensome and costly multiple filings that are of no benefit to other taxpayers in the jurisdictions concerned. Any breakdown of the system followed by retaliation will significantly raise the industry's costs.

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In the present environment where many states in the U.S. are trying to impose taxation on international air transport despite the federal tax treaties granting reciprocal exemption, the question must be raised: is it rational for the U.S. not to speak with one voice in international commerce? We will not address in depth the issue as affected by American constitutional law. However, we are all familiar with the most recent Japan Line case which upheld the "Home Port" doctrine based on an existing body of case law. Recognizing the danger of the threat posed by Japan Line, the ATA filed an amicus in that case, supporting the doctrine, as did the Solicitor General on behalf of the U.S. administration. In the opinion, the eight Supreme Court Justices said ". . . a court must also enquire. . . whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments'. If a tax contravenes. . . these precepts, it is unconstitutional under the Commerce Clause."

We realise that the whole area of the right of states to tax is a subject in which we have neither the competence nor the right to interfere. However, we do agree with the U.S. Supreme Court that one sovereign jurisdiction signing a treaty with another sovereign jurisdiction must take the necessary steps within its own territory to ensure that the aims and intentions of a treaty are upheld both in the spirit and to the letter.

It should be emphasized that the air transport industry is not opposed to paying taxes in a reasonable manner, for example, real estate taxes on local property.

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We now turn our attention to the concept of "competitive disadvantage". As a result of tax exemptions, this argument has been raised by some airlines in the U.S. as a reason for opposing reciprocal exemption. It is said that because of the fifty state (not to mention the countless local) taxing jurisdictions in the U.S. the airlines of that country pay taxes the foreign airlines do not face in their home countries. We maintain that that is fallacious and the comparison is not correctly made.

Just as the U.S. airlines must pay taxation on their domestic operation in the U.S. the airlines of other countries must pay the same on their domestic operations in their own countries. It can be confirmed that, for example, British Airways, Lufthansa and Alitalia pay taxes on their domestic operations in their own countries which they do not have to pay on their international operations. Obviously, the U.S. domestic market is much larger than the domestic market of any other country. Therefore, the U.S. airlines earn more revenue and purchase more goods and services for their domestic operation than do the carriers of other countries on their domestic operation. Hence, they pay significantly more on the domestic taxation than do airlines from other countries.

On the other hand, other countries do not tax international services in the way certain states are trying to tax the international operations of airlines in the U.S. We support any attempts by the U.S. airlines to seek exemptions from taxation on international operations.

There was a time when such a benefit would primarily interest a few large U.S. international airlines such as Panam and TWA, but nowadays many U.S. airlines have international operations. We note that over 20 U.S. airlines have at least one international sector which benefits from the tax treaties signed by the United States Federal Government and strictly honored by the other countries.

To sum up, we maintain that if one compares like with like, there is no competitive disadvantage in reciprocal exemption and that U.S. airlines operating in foreign commerce would benefit by riding on the coattails of the foreign airlines in trying to uphold the application of reciprocal exemption for foreign operations against the attempts of the states to tax these operations.

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In conclusion, I would like to summarize overall our position:

- ○ multiple reciprocal exemption has significant advantages for the air transport industry;
- ○ any attempts to undermine the regime of reciprocal exemption will result in a significant increase in costs for all airlines operating in international commerce;
- ○ it would be virtually impossible to reconstruct the multilateral reciprocal exemption regime which exists today;
- ○ domestic and international airlines are not the same and cannot be treated alike;
- ○ the foreign airlines should be exempt from domestic taxation in the U.S., as the international U.S. carriers are exempt abroad.

ADDENDUM

A case currently in litigation and known as the "LACSA case"[3] is expected to have a major impact on the international airline industry. LACSA underscores the problems of domestic taxation of products used in international air transport.

In early 1983, the State of Florida imposed excise taxes on fuel purchased within its borders for use by international and domestic airlines. A group of Latin American and Caribbean carriers instituted legal proceedings in Florida challenging this under certain provisions of the United States Constitution. In essence, they argued that taxes of this sort are undue burdens on international commerce, interfere with the ability of the United States Government to conduct its foreign relations, are inconsistent with international obligations of the United States, and unfairly discriminate against international airlines. The court before which the case was tried issued a favourable decision in June of 1983. That ruling was appealed directly to the Florida Supreme Court.[4] In June of this year, the Florida Supreme Court reversed the lower court ruling. The participating carriers filed a Petition for Rehearing of this Supreme Court decision, which was refused, on 12 September 1984, and the group has filed a Notice of Appeal placing this matter before the United States Supreme Court.

The issues in this case are broad and extend far beyond the relatively narrow confines of Florida. In most respects, the Florida fuel tax is representative of the type of levies that have been imposed in other jurisdictions in the United States or are currently under active consideration. Therefore, a decision in the Florida fuel tax case is likely to be viewed as the leading precedent in evaluating the legality of similar taxes in other American jurisdictions. Additionally, it can be expected to influence the actions of state legislatures and executive agencies in determining whether international airlines should be subjected to this and other similar forms of taxation.

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[3] *Lineas Areas Costarricenses, S.A., et al.,* v. *State of Florida, Department of Revenue;* U.S. Supreme Court – Jurisdictional Statement [notice of Appeal] No. 84-922.

[4] *Department of Revenue v. Lineas Areas Costarricenses, S.A., et al.,* v. *Department of Revenue;* Supreme Court of Florida – No. 63989 [14 June 1984].

INDIA:

The 1985-86 Budgetary Measures

By S. Gunasekaran

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I. INTRODUCTION

The Union Finance Minister, the Honourable Viswanath Pratap Singh, presented his maiden budget on the floor of the Parliament on 16 March 1985. It is the first budget, since T.T. Krishnamachari's (former Finance Minister) time, which is so comprehensive and imaginative, in that it deals vertically with the economy and the society, with industry and corporations, middle class, the well-to-do, the poor, the farmers and even the dead – each sector of the society has been given tailored treatment. However the budget has been described as pro-rich and pro-capitalist[1] and the country has been put on the road to capitalism. This budget has four-fold importance: i) this is the first budget of the newly elected Congress (I) Government headed by the young Prime Minister the Honourable Rajiv Gandhi, ii) it is synchronising with the first year of the country's Seventh Five Year Plan, iii) people gave a massive mandate to Rajiv Gandhi in the last December 1984 Lok Sabha[2] poll, and expect considerable relief and benefits from this budget, and iv) the agricultural production and the industrial output have reached the expected level in 1984-85 providing a suitable economic base for further growth. This is evident from the economic survey presented by the Finance Minister on the eve of the budget. According to the survey, the economy is in a much stronger position at the beginning of the Seventh Plan than it was at the beginning of the Sixth Plan. In section II of this paper we discuss the political issues related to the December 1984 Lok Sabha elections. In the third section we examine the general economic background of the country. The fourth section deals with the welfare programmes, the fifth with the tax proposals. The sixth section identifies the budgetary gaps and the last section gives the concluding remarks.

II. POLITICAL BACKGROUND

During the December 1984 Lok Sabha elections the Prime Minister repeatedly promised to make the common man's life easier. The election manifesto assured simplification of the tax structure by dealing seriously with tax evaders and black money hoarders. The new Prime Minister not only promised to eradicate poverty and create more job opportunities but also promised a clean and an efficient administration. This is because about 50% of the people are living below the poverty line even after the Central and State governments spent enormous amounts on various development and welfare schemes. In short, the Prime Minister has promised to achieve growth with social justice. President Zail Singh in his address to the joint session of both houses of Parliament also declared the election promises as the new Government's policy. As a first step, Rajiv Gandhi adopted an anti-defection bill (see box) in the last session of the Parliament which aims at improving the political ethics of the country. It will be interesting to note, in the following, whether the party's election promises have been reflected in the 1985-86 budget or not.

III. ECONOMIC BACKGROUND

The Finance Minister, in his economic survey presented in the Parliament, was happy about the economic performance of the country and Table 1 proves this. But there are also areas of weakness which could impede progress unless remedial measures are speedily initiated. The pre-budget economic survey calls for a marked improvement in the resource position to meet the increased development expenditure for the Seventh Five Year Plan. A significant feature of the Sixth Five Year Plan was the satisfactory performance by the agricultural sector particularly with respect to foodgrains. The monsoons have been favourable during the Sixth Plan Period, but the strategy of providing critical inputs like irrigation, fertilizer and seeds of high yielding varieties has also played an important role. With this, agriculture has been strengthened substantially. The industrial growth rate was rather disappointing, i.e. 5.8% per year in the current plan and an expected growth rate of 8 to 9% in the Seventh Plan.

Table 1

Major economic indicators: 1984-85

Indicators	1984-1985
Agricultural production (million tonnes)	151.5
Buffer stock (million tonnes)	23.0
Gross national product (percentage)	4.0
Industrial output (percentage)	7.6
Sixth Plan annual average growth rate (percentage)	5.2
External debt services (Rs. in crores[3])	1,115.0

On the other hand, the balance of payments, which had improved considerably in 1983-84, showed a further improvement in the current year. The survey also notes that as a percent of GDP the trade deficit declined from 4.6% in 1980-81 to 3% in 1983-84 and it is likely to be even lower in 1984-85. With this background, the Finance Minister presented the budget for 1985-86.

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1. Dr. G. Thimmaiah, The Week, 31 March – 6 April 1985, p. 18.
2. Lok Sabha is the Indian Parliament.
3. 1 crore = 10 million.

ANTI-DEFECTION BILL

The Anti-defection Bill disqualifies members of Parliament or State Legislatures who leave a political party or are expelled from it. A notable feature of the Bill is that the ban on "defection" also covers independent and nominated members. The bill provides that an independent member of Parliament or a State Legislature shall be disqualified if he joins any political party. A nominated member who is not a member of a political party or does not join one within six months shall be disqualified if he joins a political party after six months. The disqualification clause will not apply in case of a split. A split will be deemed to have taken place if not less than one third of the membership of a parliamentary party leaves the party. There will be no disqualification in case of a merger. A merger will be deemed to have taken place if not less than two thirds of the membership of the parliamentary party concerned agree to the merger. If a group in the original political party does not accept merger and opts to function as a separate group, it, too, will not be subject to the disqualification clause. (See *The Times*, Bangalore, of 25 January 1985.)

IV. WELFARE PROGRAMMES

The overall impact of the maiden budget of V.P. Singh is welcomed by all sections of the society because it tries to please the masses more than it burdens them. To tackle mass poverty, positive measures are required. The crop insurance and social security measures are for the welfare of the weaker sections. These are laudable measures to bring the unorganised rural sector – small, marginal farmers and agricultural labourers – into the main stream of the economy. However, we have to wait and see how far these programmes will be successful. The Central Government cannot monitor these programmes and schemes directly, and hence they have to be entrusted to the State Governments. But the available research studies show that the centrally sponsored schemes like Integrated Rural Development Programme (IRDP), National Rural Employment Programme (NREP), etc., have not helped the genuinely needy because of pilferages, leakages and political interventions in the system. In spite of this, if the centre entrusts these additional programmes to the states, then the very purpose of these programmes will be defeated. The Central Government should evolve a machinery for checking and monitoring the working of the various centrally sponsored programmes at all stages. Another concession announced by the Finance Minister is the fertilizer subsidy to the tune of Rs. 1,801 crores. This no doubt would benefit the rural "kulaks" instead of the rural poor.

V. TAX PROPOSALS

In the field of direct taxes, the Finance Minister announced many proposals which would benefit the salaried and the middle classes. The name of the middle class has been used to camouflage the concessions given to the rich. Some of the concessions given to the middle class are:

(i) the exemption limit for personal income tax which is raised from Rs. 15,000 to Rs. 18,000, and also a reduction in the tax rate at all levels of income, which is presented in Table 2;
(ii) the discontinuance of the surcharge on income tax in the case of all categories of non-corporate taxpayers;
(iii) the abolition of the Compulsory Deposit Scheme from 1 April 1985;
(iv) the increase of the wealth tax exemption limit to Rs. 2.5 lakhs;[4]
(v) a 5% reduction in the rates of corporate income tax and the lowering of the interest rates of the corporate sector;
(vi) the abolition of the estate duty from 19 March 1985; and
(vii) the increase of the MRTP (Monopoly Restrictive and Trade Practices) asset limit from Rs. 20 crores to Rs. 100 crores.

Table 2

Income tax reliefs for select incomes

(comparative tax in rupees at selected levels)

Taxable income	Existing rate including surcharge	Proposed rate without surcharge	Relief
16000	225	Nil	225
17000	450	Nil	450
18000	675	Nil	675
19000	900	250	650
20000	1125	500	625
21000	1406	750	656
22000	1688	1000	688
23000	1969	1250	719
24000	2250	1500	750
25000	2531	1750	781
30000	4219	3250	969
40000	8156	6250	1906
50000	12656	9250	3406
60000	17719	13250	4469
70000	22781	17250	5531
80000	28406	21250	7156
90000	34031	25250	8781
100000	39656	29250	10406

The above tax concessions are a great relief to the middle class, especially the salaried people. As a result of this, their savings and investment potential may increase in the coming years. A reduction of corporate income tax and a tax holiday for 5 years are intended to encourage the industrial – mostly the private – sector. The Federation of Indian Chambers of Commerce and Industry (FICCI) suggested that the MRTP limit be raised to Rs. 50 crores from Rs. 20 crores, but the Finance Minister raised it to Rs. 100 crores. It was a pleasant surprise for the monopoly houses but a jolt to others. The greatest beneficiary is the corporate sector. Now the doors are wide open for foreign investment.

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[4] 1 lakh = 100,000.

To what extent this will promote industrial growth will depend upon the industrial policy of the new Government, which will be presented in the current session of the Parliament.

In the case of indirect taxes, which are a major revenue fetching item, V.P. Singh has hiked the tax rates on some commodities and also announced some tax concessions and exemptions. They are:

(i) A 15% hike in the prices of all petroleum products which came into force from midnight 16 March 1985.

(ii) The excise duty on commercial vehicles and three axled vehicles goes up, but a 2% duty concession for turbocharged commercial vehicles and passenger cars is given. The excise duties on cement and commercial vehicles would benefit the state governments by fetching higher tax revenues. As this comes under sharable tax items, according to the recommendations of the Eighth Finance Commission, the estimated states' share of the additional revenue is Rs. 132 crores. But the bulk of the taxes is expected from the non-sharable customs duty on petroleum products. The increase in excise duties of commercial vehicles and the hike in customs duty on petroleum products would affect the common man. The above two duties may force the State Governments to increase the transport fare. In such an event, it would create an embarrassing situation for the State Governments. This action will affect to a large extent the urban poor and the middle class, whose mode of transport is mainly the State owned transport services. In this connection, we may recall the hike in train fares of the suburban transit system in the railway budget presented by Bansi Lal in the parliament. All these would mostly affect the weaker sections of society.

(iii) Advanced types of computers not manufactured in India are exempted from customs duty, and considerable concessions are given to the electronic industry. This reflects the young and dynamic Prime Minister's wish to encourage those industries with greater potential and thus set into motion an era of science and technology. However, this sort of encouragement to use more computers may replace manual labour, which is abundant and cheap in our country. As is well known, unemployment is the pivotal problem in our country. Hence, it is the duty of the Government to see that the problem of unemployment is not further aggravated by its actions.

(iv) The abolition of licence fees for radio, television sets and VCRs is a noteworthy feature. However, abolition of licence fees for VCRs is yet another example of the budget being pro-rich.

(v) The export duty on 12 items, including iron ore, manganese ore and animal products is abolished. The special excise duty also has been abolished on 100 items, including computers. This shows that the Finance Minister is interested in more and more exports, and to thus help India to earn more foreign exchange. If the foreign exchange position is not altered much in the future then all these concessions to various commodities will be a waste.

(vi) The customs duty on pulp for the paper industry is abolished, imported raw hides and skins are fully exempted from duty, anti-tuberculosis and anti-leprosy drugs are totally exempted from duty and zip fasteners are to be fully exempted from excise duty. The above tax concessions may be appreciable. However, increasing the duty of some of the basic goods like bidi (an indigenous cigarette used by the common man), soap, batteries, kerosene etc., should have been avoided, as these are used by all sections of the population in their day to day life irrespective of their economic status.

Some of the other proposals are:

(i) the bonus limit being raised from Rs. 750 to Rs. 1,600 per month, but the eligibility criteria remaining the same;

(ii) the inclusion of "dearness allowance" for the calculation of retirement benefits, and

(iii) enhancing the death-cum-retirement gratuity from Rs. 36,000 to Rs. 50,000. These may be welcomed by the Central Government employees.

The planned investment in the Central sector for 1985-86 is expected to be Rs. 18,500 crores, which is Rs. 1,149 crores higher than in 1984-85. Priorities will be given to complete the projects already in operation rather than going in for new projects. A clear picture about the exact amount of planned investment will emerge only after finalising the states' annual plan. In case the Central investment in the public sector is less when compared to last year's then the responsibility of reshaping the economy rests on the private sector. If the states' share is less, then the states will face a financial problem.

For the first time the Government has legalised a company's donation to various political parties. The main aim of this action is to allow black market money to flow to some extent into the economic mainstream and also allow the corporate sector to play a legitimate role within the defined norms to help in the functioning of our democracy. This may curb black market money to some extent but not fully.

VI. BUDGETARY GAP

The budget estimate for 1985-86 shows a revenue receipt of Rs. 27,083.77 crores. Of this Rs. 310.95 crores are due to the effect of new tax proposals. The revenue expenditure is Rs. 32,717.66 crores and thus the deficit is to the tune of Rs. 5663.89 crores on revenue account. In the capital account V.P. Singh shows a surplus of Rs. 2284.96 crores, even though the revised estimate for 1984-85 shows a deficit of Rs. 616 crores. Hence, after taking into consideration both the revenue and capital account for 1985-86, the overall deficit is to the tune of Rs. 3348.93 crores. The huge uncovered deficit gap may lead to an inflationary pressure in the economy in the coming years. It would not be surprising if this deficit increases to Rs. 6,000 crores at the end of this financial year. This is evident from past experience. In the 1984-85 budget estimate, the deficit was Rs. 1,773.47 crores, which increased to Rs. 3,984.57 crores in the 1984-85 revised estimate. It almost doubled. Even though it doubled, inflationary pressure was under control in 1984-85 because the agricultural production and the buffer stock position was high. The Budget at a glance is given in Table 3.

Table 3
Budget at a glance
(in crores of rupees)

Particulars	1984-85 Budget estimate	1984-85 Revised estimate	1984-85 Budget estimate
Revenue receipts	24,005.13	24,931.58	26,772.82 310.95
Revenue expenditure	26,341.99	28,300.15	32,717.66
Revenue surplus/ Deficit	−2,336.86	−3,368.57	−5,663.89
Capital receipts	16,756.93	17,777.82	20,862.59
Disbursements	16,193.54	18,393.82	18,577.63
Capital surplus/ Deficit	+ 563.39	+ 616.00	+2,284.96
Overall deficit	−1,773.47	−3,984.57	− 3,348.93

* Effect of Budget proposals.

The reason for the increased deficit in 1984-85, as pointed out by V.P. Singh, is the substantial rise in the expenditure on defence, food and fertilisers, subsidies and payment of DA to Central Government employees. If the country moves on the same line, our estimated deficit at the end of the current financial year (1985-86) may come true. To avoid this, the new Government should give priority on the price front especially to the commodities consumed by the common man. In this context, one of the economists in the pre-budget survey suggested that our economy should have a deficit of Rs. 1,000 crores at present. But anything exceeding this would increase the current inflation to two digits as from next year. However, this huge deficit is unwarranted due to the new tax reliefs and proposed concessions for the welfare of the down-trodden. In case of a monsoon failure or if the industrial sector cannot increase its output, the deficit may affect the economy to a greater extent. If this happens, the sufferers will be the poor and, in this context, it is termed an anti-poor budget.

VII. CONCLUSIONS

To conclude, the new India budget has made an honest attempt in introducing some dynamic package programmes like crop insurance, social security measures, raising the personal income-tax limit, retirement benefits etc. In a way it has departed from the past. However, a shrewd Finance Minister could have avoided taxing the basic goods like soap, bidi, batteries, kerosene, etc. which are used by the common man. On the whole, the budget has belied the common man's aspirations and dreams but has favoured the elite class. Since this is the first budget of the young Prime Minister, people can expect better result-oriented budgets in the years to come.

In next issues:

Taxation in the People's Republic of China (Tax Laws – Tax Incentives – Tax Treaties) A brief Introduction – by *Eugen Jehle*

Canada: Some Current Issues with Treaty Tax-sparing Provisions – by *Nathan Boidman*

Belgian Coordination Centers Prove Success – by *Patrick L. Kelley*

The Role of Tax Treaties as an Instrument of Economic Cooperation between "Capitalist" and "Socialist" Countries – by *Helmut Debatin*

Collaboration Agreements – Some Issues – by *M.B. Rao*

U.K. Taxation and Currency Fluctuations – by *Jill C. Pagan*

United Kingdom: A New Approach by the Courts after Furniss – by *John Avery Jones*

The Policy and the Practice of the United Kingdom in the Tax Treatment of Transfer Pricing – by *M.H. Collins*

The Treatment of Spouses' Incomes in Schedular and Global Models of Income Taxation – by *Sylvain R.F. Plasschaert*

Nigeria: Analysis of Some Tax Issues in the 1985 Federal Government Budget – by *A.C. Ezejelue*

THAILAND:
New Withholding Taxes

Information supplied by Mr. Montri Hongskrailers, Coopers & Lybrand Associates, Bangkok.

On 26 November 1984, the Ministry of Finance issued Ministerial Regulation no. 163 authorized under the Thai Revenue Code which specified the new withholding tax rates for many additional individual incomes. On 3 January 1985 the Thai Revenue Department issued Order no. Tor. 4/2528 clarifying the particular cases of incomes to which the new rates apply. These new withholding taxes supplement the existing withholding tax system[1] and became effective on 1 February 1985. A survey of the new withholding taxes follows.

1. Companies and partnerships which have the status of a legal entity[2] and which purchase certain agricultural products – i.e. rubber sheet, cassava, jute, corn, sugar cane, coffee beans, oil palm seeds and rice – must withhold 0.75% tax on the purchase price paid if the seller is an individual or legal entity subject to income tax.
2. Companies and other legal entities (including registered partnerships, which have the status of a legal entity) must withhold 2% tax on any payments made with respect to advertising or on fees for professional services rendered, provided that the recipient – i.e. the supplier of the service – is an individual or legal entity subject to income tax. Professional services for purposes of this provision are those rendered in the fields of law, medicine, engineering, architecture, accountancy and fine arts provided that the persons rendering the service are domiciled or resident in Thailand or carry on their activities in that country.
3. Banks, as defined under the Law on Commercial Banking, and companies, as defined under the Law concerning the carrying on of the business of finance, dealing in securities and the granting of real property loans, must withhold tax on interest they pay with respect to deposits or treasury notes. The rate of the tax is:
   - 1% if the recipient is a company or a partnership having the status of a legal entity, except if it falls under category 2, below;
   - 5% if the recipient is a foundation or association carrying on a lucrative business (with the exception of those which are exempted from income tax by the Minister of Finance).
4. Companies and other legal entities (including registered partnerships) as well as persons or partnerships which do not have the status of a legal entity and other entities which receive income from business, trade, agriculture, industry or transport must withhold tax on payments to certain categories of persons at the rate of:
   - 5% if the recipient is only subject to income tax on prizes for competitions etc.; and
   - 3% if the recipient is a public performer (formerly 0.75%).
5. Any person – i.e. company, legal entity (including registered partnerships) or other entity not having the status of a legal entity which makes payments to contractors for work performed by the latter must withhold 5% tax on the contract price, provided that the contractor is a legal entity or a partnership having the status of a legal entity created under foreign law and carries on its business in Thailand without having a permanent establishment (office) in that country.

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[1] The present system of withholding taxes, summarized is:

(a) Withholding tax applicable to domestic companies and to foreign companies carrying on business in Thailand:
- all types of income paid by Government, governmental organizations, municipalities or any other local authority are subject to withholding tax at the rate of 1% of the gross amount;
- income in the nature of proceeds from the transfer of real property is subject to withholding tax at the rate of 1% of the gross amount;
- interest on deposits or on promissory notes paid by commercial banks, finance or securities companies or mortgage loan banks to all companies or legal partnerships carrying on a business in Thailand are subject to withholding tax at the rate of 1% of the gross amount; and
- payments made by all companies or legal partnerships for the purchase of certain agricultural products such as rice, rubber, maize, etc. are subject to withholding tax at the rate of 0.75% of the gross amount.

(b) Withholding tax applicable only to foreign companies not carrying on business in Thailand:
- income in the nature of fees, brokerage, discounts, or any other kinds of income derived from service rendered in Thailand;
- royalties of any kind;
- interest on bonds, deposits, and other similar income;
- money or any other benefits derived from letting out properties on hire; and
- income from liberal professions.

All payers of such income are required to deduct the corporate income tax at the rate of 25% after standard deductions. However, if the income is a dividend, the rate is 20% of gross dividends. If the income is interest and the recipient carries on banking, insurance or a similar business, the rate is 10% of the gross interest.

[2] Under Thai company law a distinction is made between unregistered ordinary partnerships, registered ordinary partnerships and limited partnerships. Only the latter two are recognized as legal entities. See *Taxes and Investment in Asia and the Pacific*, Part II, Thailand, Section B.1.2.

BOTSWANA:

Budget 1985

By D.K.U. Corea

LIVESTOCK VALUATION

Certain modifications have been proposed in respect of the basis of livestock valuation for farming purposes.

(a) Certain working animals such as mules and donkeys are presently included in the table of standard values for livestock valuation purposes.
It is proposed that these animals will not form part of the value of livestock for the purpose of ascertaining farming profits at the end of a tax year.

(b) It was stated that the distinction between livestock purchased for breeding purposes and other livestock will be removed. At present other livestock may be valued either at market value or the standard values published in the first schedule of the income tax act. Livestock purchased by a farmer for breeding purposes (e.g. a stud bull) is valued at purchase price. It is assumed that such a breeding stock may, according to the proposals, be valued in future at either market value or standard value. The standard value is considerably less than the cost of a bloodstock animal. Hence it would appear that the proposal has the effect of providing a lump sum allowance on purchase of bloodstock which should add incentive to improving the quality of the national herd.

STATUS OF MARRIED WOMEN

The minister re-affirmed the proposals mentioned in the last budget speech concerning the status of married women. It was stated that the most practicable course at the present time is to give a married couple the right to elect that the wife should be the person to whom tax is chargeable instead of the husband. The effect of this proposal is set out below.

A married couple may elect for the wife to be the taxpayer ("head" of the family for tax purposes) instead of the husband. Since husband and wife are effectively taxed separately under the existing provisions of the act this proposed change should not affect the ultimate amount of tax paid by a family except for a marginal effect on the personal allowances allowed as a deduction against the income of each spouse. This is seen as a unique feature of tax legislation to consolidate the status of women in the income tax act.

It was also stated that certain other provisions which appear to be discriminatory (as regards the status of women) will also be amended.

PAYE AS FINAL TAX CHARGE

It is proposed that a scheme will be introduced where PAYE will be a final tax on those taxpayers who have no income other than remuneration from employment and where the relevant income is below a certain amount. A standard deduction will be allowed in lieu of allowance claims for education, medical expenses, insurance and superannuation contributions.

It was mentioned that the scheme is voluntary and will not prevent an employee claiming a refund nor the commissioner assessing an employee in the normal way if circumstances warrant doing so.

It is estimated that about 20,000 employees will fall within the system and the obvious administrative advantages would be to allow the department of taxes to re-allocate resources towards proper assessment of taxpayers in the business sector.

CAPITAL TRANSFER TAX

The Capital Transfer Tax Bill and the Death Duties (Repeal) Bill which were published in June 1983 were subsequently deferred following representations by the House of Chiefs. The minister announced his intention to proceed with the bills as soon as the necessary consultations have been completed to resolve the apparent misgivings.

The Capital Transfer Tax Bill was presented on 18 April 1985 in the parliament.

GUINEA:
New Investment Code

By Servaas van Thiel

Mr. S. van Thiel is research associate at the International Bureau of Fiscal Documentation, Amsterdam.

1. INTRODUCTION

In 1962 Guinea was the only former French colony that decided against any further association with France. Late president Sekou Tourée, at that time, spoke his famous words: "We prefer poverty in liberty to richness in slavery", thereby guiding his country away from a western style free market economy to a centrally planned economy with little room for private enterprise. It was only in the late Seventies that a change of attitude occurred. Foreign investors were invited to help develop Guinea's national resources and an investment code was enacted in 1980. On 3 October 1984 a new investment code,[1] repealing the previous one, was announced by the President of the Republic and reflected an even more positive attitude towards private investment.

The Code defines the conditions under which private investors may be offered guarantees and benefits for investments that help to further the objectives of the national economic and social development plan. The administration of the law is entrusted to a National Investments Commission under chairmanship of the Minister for the Economic Plan and Statistics. The National Investments Commission will evaluate applications and oversee the fulfillment of obligations entered into by private investors.

Certain economic sectors, including mining, forestry, water and specific strategic sectors to be further defined by the Government, are reserved to the State or Guinean nationals. Investment in these sectors by foreign persons (defined as non-nationals) or foreign enterprises (defined as enterprises controlled by non-nationals) is possible but requires prior authorization.

Some economic sectors are considered to be priority sectors. They include agriculture, fisheries, processing of primary animal, vegetal and mineral products, production of fertilizers, forestry, mineral research and production, production of energy (including hydrocarbon products), transport, telecommunications, health, education, tourism, public housing construction, development banks and credit institutions. This list is given in the investment code but can be modified by the Minister of the sector concerned, on recommendation of the National Investments Commission.

The investment code defines 4 schedules (1 general and 3 special) under which new investment may be placed. The application procedure for the general schedule is not specified in the code.

The procedures for the 3 special schedules (A, B and C) are initiated by filing a request with the Secretariat of the National Investments Commission.

The request must indicate the motives for the project within the required schedule. Admission to schedules A and B is granted by ministerial decree and admission to schedule C is effected by signing an "establishment contract"[2] which is subsequently ratified by Presidential decree. In order to facilitate the exploitation of natural resources, investors applying for schedule C may receive preliminary approval to do research and feasibility studies. The approval document indicates the aim and nature of the investment project, its location, its implementation period, the applicable schedule and all conditions or obligations which may be determined therein.

2. INVESTORS ELIGIBLE FOR INCENTIVES

General conditions

In principle all economic activities, whether resulting from the creation of a new enterprise or the extension of an existing one, can be approved and accepted under the general schedule or one of the 3 special schedules as defined in the investment code.

A general condition requires that the project fit within the objectives of the national development plan. In this respect, important elements are the satisfaction of national needs, national value added and transformation of national resources, spin off effects on other economic sectors, creation of labor and training of Guinean workers, promotion of economically less developed regions, foreign exchange earnings, establishment of the center of management in Guinea, and conformity of the project with the economic policy of the government.

A second set of conditions requires that the investor commit himself to implement the planned investment, to adhere to national and international standards of quality, to draw up accounts according to Guinean standards and to have them certified by a Guinean registered accountant, to give priority to the use of national products and labor, to keep a constant level and quality of investment and use its own capital, rather than loans, to a minimum of 25% of total investment, to publish a list of goods and services required to carry out the project in the bulletin of the "Chambre Economique et Consulaire" and one newspaper, to publish a program of training and promotion of local labor and not to use goods under one of the schedules for any other purpose for a period of 5 years after expiration of the special schedule. Violation of these conditions may lead to the withdrawal of the benefits granted under one of the schedules.

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[1] Ordonnance No. 239/PRG/84, Code des Investissements.

[2] An "establishment contract" is the contract entered into by the foreign investor and the host government clarifying the conditions governing the investment.

Schedule A

Schedule A applies to small and medium-sized enterprises. Special conditions for admission are the following:

(i) total investment of a minimum of 10 million sylis and a maximum of 50 million sylis, to be fully paid within 2 years;

(ii) a minimum of 30% of total investment must be financed through capital investment or loans that resemble capital investment. Capital investment is defined as all contributions in cash or in kind for issued shares and participations in an enterprise. Loans that resemble capital investment are defined as long-term loans (over 10 years) that enable the company to obtain necessary bank credits (but not exceeding 50% of its own capital);

(iii) work must be created for at least 10 Guinean nationals;

(iv) the enterprise must be national, i.e. a Guinean enterprise in which the majority interest is held by Guineans which are autochthones with a father or mother of Guinean nationality whose ascendants have been Guinean for at least 4 generations. A Guinean enterprise is an enterprise in which Guinean nationals have a majority participation and therefore a predominant influence on the management;

(v) throughout the investment period an amount of its own capital must be maintained equalling at least 25% of total investment.

Schedule B

Special conditions for admission to schedule B are the following:

(i) total investment must exceed 50 million sylis to be fully paid within 3 years;

(ii) a minimum of 40% of total investment must be financed through capital investment;

(iii) work must be created for at least 20 Guinean nationals;

(iv) total investment must be financed by foreign resources in the same proportion as capital investment has been financed by foreign persons (i.e. national or legal persons not having Guinean nationality);

(v) throughout the investment period an amount of its own capital must be kept equalling at least 25% of total investment.

Schedule C

Special conditions for admission to schedule C include the following:

(i) total investment must exceed 700 million sylis to be fully paid within 5 years;

(ii) a minimum of 40% of investment must be financed through capital investments;

(iii) work must be created for at least 100 Guinean nationals for a minimum of 280 days a year;

(iv) total investment must be financed by foreign resources in the same proportion as capital investment has been financed by foreign persons;

(v) throughout the investment period an amount of its own capital must be maintained equalling at least 25% of total investment.

3. INVESTMENT INCENTIVES

In general

The investment code provides for 3 general investment guarantees concerning non-expropriation, repatriation of investment proceeds and national treatment of investors and expatriate personnel.[3] These guarantees are applicable on the basis of reciprocity.

The State of Guinea guarantees not to expropriate or nationalize private investments unless for reasons of legally established public utility and on the condition that the measure is not discriminatory nor contrary to a specific obligation entered into by the Guinean State and that at the moment of expropriation provision is made for the payment of just and adequate compensation in accordance with the rules of international customary law. In addition, the investment code provides for a dispute settlement procedure in accordance with the 1965 International Convention on the settlement of disputes between states and nationals of other states, an international procedure provided by the world bank.

The investment code guarantees the free repatriation of foreign capital, investment income and liquidation proceeds or compensation payments in case of expropriation. Foreign enterprises regularly established in Guinea receive national treatment in respect of rights of all nature including immovable rights, intellectual property rights, mineral and forestry concessions, authorisations and administrative licenses, participation in public markets, access to courts etc.

They cannot be subjected to higher taxes than national enterprises. Their personnel, while exercising their duties, receive national treatment in respect of social laws, freedom of movement and union activities. A foreign enterprise is defined as an enterprise in which foreign persons have a majority participation and therefore a predominant influence on the management of the enterprise.

General schedule

The general schedule provides for the guarantee that no new enterprise will be subjected to any other formalities other than those resulting from applicable law.

Schedule A

Schedule A has a duration of 4 years (or 6 years for enterprises located in less developed areas) and provides the following incentives:

(a) The Guinean State will grant the qualifying enterprise the use of necessary sites.

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[3] National treatment indicates that foreign persons will not be treated less favorably than national persons.

(b) Guinean enterprises have priority in government procurements and in the granting of public credits or loans. The State can also provide protection against foreign competition and reduce export duties..

(c) Enterprises have the right to freely obtain foreign exchange necessary for remuneration of expatriate personnel, for reimbursement of the principal and interest on approved foreign loans and for necessary imports to establish the approved investment.

(d) The State will not interfere with the management of the enterprise nor with pricing policies subject, however, to existing legislation; the enterprise will have the right to import and export.

(e) The following tax incentives are granted for the period necessary to implement the investment:
- exemption from import duties and indirect sales taxes on goods and services necessary for the continuation of the investment project to a maximum of 10% of F.O.B. value. For agricultural, water and forestry projects an exemption from import duties is granted in respect of fertilizers, live animals and vaccinations and medicines;
- exemption from corporate registration duties, transfer duties on immovable property, taxes on capital acquisition and shares;
- exemption from the flat rate tax on industrial and commercial income;
- exemption from tax on income from movable property for shareholders or participants in the enterprise for the duration of the special schedule;
- exemption from tax on interest paid on approved loans.

Schedule B

The duration of schedule B is 8 years (10 years for enterprises located in less developed regions) and it provides the following incentives:

(a) all incentives granted under schedule A, plus

(b) enterprises can benefit from a fiscal stabilization clause which freezes their tax liabilities for a period of 6 years (subject to international treaties and establishment contracts entered into by Guinea).

Schedule C

The duration of schedule C is 15 years with a possible extension for another 5 years, and it provides the following incentives:

(a) all incentives granted under schedule A, plus

(b) enterprises can benefit from a fiscal stabilization clause which freezes their tax liability for a period of 15 years;

(c) enterprises can benefit from other tax incentives and guarantees as may be specified in the establishment contract.

Conference Diary

JULY 1985

Hartford Institute on Insurance Taxation: Second Annual International conference on Insurance Taxation. Montreux (Switzerland), 1-3 July (English).

World Peace Through Law Center: The Tax Panel discusses: Taxation, National cooperation encourages international trade. Berlin (West), 21-26 July (English, French, Spanish, German).

SEPTEMBER 1985

39th Annual Congress of I.F.A.: I. The assessment and collection of tax from non-residents. II. International double taxation of inheritances and gifts. London (United Kingdom), 8-13 September (English, French, German, Spanish).

Interphil: Interphil II (International Standing Conference on Philanthropy): Increasing government reliance on voluntary action – crisis or challenge? (including: comparative tax incentives for companies). Workshops on tax concessions and incentives to greater giving (a) by nation and (b) by international agreements. Venice (Italy), 26-28 September (English).

OCTOBER 1985

Asian-Pacific Tax & Investment Research Centre: Third Asian-Pacific Tax Conference. Kuala Lumpur (Malaysia), 7-8 October 1985 (English).

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: International tax law and tax planning (Seminar). St. Gallen (Switzerland) 21-24 October (German).

SEPTEMBER 1986

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European Study Conference Limited, Kirby House, 31 High Street East, Uppingham, Rutland LE 15 9PY, United Kingdom.

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

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CANADA:

Premiums Paid to Offshore Captive Insurance Company

(Consolidated – Bathurst Limited v. Her Majesty the Queen[1])

This note was written by **Patricia Dunn, J.D.**, managing editor of the *Bulletin for International Fiscal Documentation.*

THE FACTS

Taxpayer, (T), an international manufacturer of pulp and paper and packaging, with some 20 to 30 subsidiaries throughout the world, found that insurance for the pulp and paper industry was difficult and expensive to obtain in Canada. T's Board of Directors decided therefore in 1970 to form an insurance subsidiary of its own. They determined that setting up an offshore subsidary was attractive both to avoid the regulation of the insurance industry that exists in Canada and to avoid Canadian taxes.

T therefore created Overseas Insurance (OI), a wholly owned subsidiary. OI never had any employees of its own but was managed under a contract by Insurance Managers Limited, a Bermuda corporation.[2]

Due to the vastness of its holdings and operations, T had at any one time a large array of insurance policies. In filing its income tax returns for the years 1972 to 1975 inclusive, T claimed as expenses the premiums paid with respect to insurance on its own property, including amounts paid directly or indirectly to OI with respect to insurance and reinsurance provided by OI on T's property.

THE ISSUE

Were insurance premiums paid by T to OI a reserve fund in the hands of OI to cover potential losses to T's property?

THE LAW

Canadian Income Tax Act[3], Section 18:

(1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of . . .

(e) an amount transferred or credited to a reserve, contingent account or sinking fund . . .

Subsection 245(1):

In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.

Arguments before the Court

Minister of National Revenue

The Minister of National Revenue (Minister) argued that, concerning premiums paid by T to OI, any amounts retained by OI, not expended in reinsurance premiums or for payment of T's losses, were not properly deductible from T's income because services provided by that "captive insurer", OI, were not insurance services[4] but rather "an elaborate scheme of self-insurance whereby [T] established a fund to bear its own risks . . . . The only property in respect of which OI undertook a risk was that of [T], and all of its revenues came directly or indirectly from [T]".[5] The Minister claimed that T had created a reserve fund in the hands of OI for paying for potential losses not covered by insurance with third parties. As such, the Minister argued, the money so directed to OI cannot be deducted as expenses. The Minister then went on, additionally, to invoke subsection 245(1).

Taxpayer

T contended that all its insurance transactions were genuine, legal and enforceable and that they were all normal insurance contracts. As the companies involved were separate entities[6] in law, it did not matter that they were interrelated and it could not be assumed that OI acted as T's agent. T contended that there was no "sham" involved and that it had entered into the insurance program primarily for business purposes without taxation being a significant consideration.

DECISION OF THE COURT

Bona fide business purposes

The Court concurred with T's statement that it had entered into its insurance program for several purposes,

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[1] Federal Court – Trial Division, 15 February 1985, reported in 8 Dominion Tax Cases 5120; cited 85 DTC.

[2] Insurance Managers Limited manages some 55 captive insurance companies which all have their head offices in Bermuda.

[3] Income Tax Act, S.C. 1970-71-72, C.63.

[4] With respect to that portion of the risk that OI retained and did not reinsure.

[5] The Court at 5123.

[6] Taxpayer's insurance scheme involved several wholly owned subsidiaries as well as deductibles and reinsurance policies with third party insurers and agents of OI.

among them being bona fide business purposes. However, the Court stated that, even if T had no bona fide business purpose, it was nevertheless bound by *Stubart Investments Limited v. H.M. the Queen*,[7] which held that a transaction may not be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose. The meaning behind *Stubart*, according to the Court, is that not only is a taxpayer not precluded from arranging his affairs to minimize his tax, but the courts would normally treat as valid arrangements made by him that have no bona fide business purpose. The corollary to this, stated the court, is that the presence of a bona fide business purpose does not immunize the taxpayer from tax liability (see comment, following).

Transactions not a sham

The Court quoted the standard definition of "sham", confirmed in the *Stubart* decision,[8] and found that because, in the instant case, the legal relationships as between the various companies and with outside insurers were all apparentely legally binding contracts giving rise to enforceable obligations and that there was no backdating, etc., as is typical of a sham, the arrangements entered into by T and its subsidiaries could not be regarded as a sham.

Artificially reducing T's income

The Court, citing several previous decisions defining "artificiality", then concluded that it must look to the facts surrounding T's "insurance" arrangements to determine whether they accord with normal concepts of insurance or whether the monies paid to OI, purportedly as premiums, should be non-deductible as artificially reducing its income.

Taking the following factors into consideration:

- there were no officers or employees of T on the board of OI;
- OI was a wholly owned subsidiary of T and one could only infer that "OI had to do whatever its parent said";[9]
- all OI's assets had their ultimate source in T;
- OI had no other customers among whom to spread the risk, nor any other source of funds from which T could be paid for losses within the area of risk retained by OI;

the Court determined that "The 'insurance program' must be seen as a device for channelling funds from [T] to one of its own instrumentalities over which it had complete control, and to which it would have to look to pay losses on risks retained by OI".[10] The net result, stated the Court, is similar to the establishmenmt of a reserve fund by any institution or corporation from which it would plan to pay for uninsured losses to its property.

The Court held, therefore, that "premiums" paid by T to OI were disbursements which would artificially reduce T's income and are not deductible, pursuant to subsection 241(1). In fact, such disbursements were in effect amounts transferred to a reserve fund and are therefore not deductible by virtue of paragraph 18(1)(e) of the Income Tax Act.

COMMENT

Rejection of bona fide business purpose

It should be noted that the Court's confirmation of the *Stubart* decision, rejecting the necessity of a bona fide business purpose as a defense to tax avoidance, is in contradiction to the recent trend in other countries, notably the U.K. and the U.S., to disregard tax planning schemes having no business purpose other than the avoidance of taxation. There is some question whether this will be of long-term benefit to the taxpayer, however, as it is thought that anti-tax legislation may be introduced that will be more severe than deemed necessary.

Interest accruing to OI charged against T

The Minister had also attributed to T amounts earned by OI in interest and through changes in the exchange rate with respect to the funds in the possession of OI. The Court held the view that income or capital gains arising from OI holding these funds were not attributable to T but rather were the property of OI. As the Court stated, "it is one thing to say that for a parent company to provide funds for a wholly owned subsidiary and then look to these funds for replacement of uninsured losses is not risk shifting and therefore not insurance, it is quite another thing that, in the absence of a [particular rule to the contrary] or sham (which was not found here) that the normal distinctions between a parent and its subsidiary should be disregarded".[11]

The Court found that in this respect the Minister's reassessment was in error and that another reassessment, that does not attribute such revenues to T, should be made.

Dicta

The Court, after reaching its conclusions, went on to rebut related defenses raised by T to justify its position.

The Court cited 3 U.S. cases[12] in an attempt to repre-

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[7] 84 DTC 6305 (1984) since followed by the Federal Court of Appeal in *H.M. the Queen v. Parsons and Vivian* (84 DTC 6447, 6452) (1984) C.T.C. 354.

[8] A sham consists of acts which are intended by them to give to third parties or to the courts the appearance of creating between the parties rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. *Stubart* at 6320, from *Snook v. London & West Riding Investments Ltd.* (1967) 1 All E.R. 518 at 528.

[9] The Court quoting *Frank M. Covert, Q.C., et al. v. Minister of Finance of Nova Scotia et al.*, (1980) 2 S.R.C.774.

[10] The Court at 5125.

[11] The Court at 5127.

[12] *Helvering v. Le Gierse* (1941) 312 U.S. 531; *Carnation Company v. Commissioner of Internal Revenue* (1981) 640 F.2d.1010, cert.den.; *Stearns – Roger Corp., Inc. v. United States* (1984) 577 F.Supp. 833 (U.S. D.Ct.).

sent a realistic analysis of relationships involving insurance, i.e. "that the essence of insurance is a transfer of risk to an individual or a corporation that is in the business of insuring the risk of *others*".[13] As the Court pointed out, in the instant case the ultimate risk remained with T. With respect to losses not insured with third parties, T was obliged to look to its own instrumentality, OI for any funds it might requires to replace the losses on its property. If the money were not there – money which came from T directly or indirectly – then T would not be recompensed for its loss, at least unless it provided the funds to its subsidiary to reimburse itself.

The Canadian Courts showed their willingness to pierce the corporate veil in such complex insurance programs when the Court stated that "[given] that Parliament specifically precluded [in para. 18(1)(e)] the deduction of amounts transferred to a reserve fund, it cannot be Parliament's intent that such a prescription can be avoided by a taxpayer capable of a sufficient array – not normally available to individuals or small businessmen – of advisors and offshore management firms to create what, if in legal terms is an insurance scheme, is in reality a reserve fund for repair or replacement of uninsured property".[14]

The Court made short shrift of T's contention that, under section 138 of the Income Tax Act, certain corporations are deemed to be insurance companies. Since OI is an offshore company and does not fall under Canadian law, stated the Court, we see no reason to even address that issue. Nor did T's contention that regulations[15] specifying that income of offshore captive insurers is deemed to be income of the Canadian parent did not come into effect until 1976, thus exempting T, have any influence on the Court. Even were such the case, noted the Court, this does not necessarily mean that such amounts were exempt from Canadian taxation if, in the particular circumstances, there were deductions not permissible under para. 18(1)(3) or subsection 245(1) of the Act.

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[13] Citing *Stearns – Roger* with approval, at 5126.

[14] The Court at 5126-5127.

[15] Foreign Accrual Property Income (FAPI) rules, adopted 1972, effective 1976.

[Continued from page 261]

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IFA news

BRITISH BRANCH

The Chairman's Report 1984-85

- The number of members on 31 March 1985 was 472 (351 individuals and 121 corporate members).
- During 1984-85 8 technical branch meetings were held at which attendance was usually in the range of 50 to 80. Three of these were on tax developments in particular countries overseas and 5 on international aspects of U.K. taxation. The Manchester sub-branch held 5 technical meetings during 1984-85.
- The number of registrations received so far (end of May 1985) for the annual IFA Congress to be held in London (8-13 September 1985) indicate that attendance will be high. Arrangements for the scientific programme have been made and, in addition to the two main subjects on *non-residents* and on taxation of *inheritance and gifts,* there will be 4 seminars dealing with (i) charities, pension funds and the like, (ii) interpretation of tax treaties, (iii) new types of financing transactions and (iv) developments in U.K. taxation. The opening ceremony will be addressed by the Rt. Hon. Peter Rees QC, MP, Chief Secretary to the Treasury.

Annual general meeting

The Annual General Meeting will be held on 20 June 1985 in the Norfolk Room at the Offices of Arthur Andersen, London (and not on 6 June as announced in the programme booklet). Six members of the Branch Committee will be elected.

Additional meeting on China

The British Branch of IFA announces that on 24 June 1985 an additional meeting will be arranged in the Theatre of the Midland Bank PLC, London. The following representatives of the People's Republic of China will attend:

Mr. Liu Zhicheng – General Taxation Bureau
Deputy Chairman and Secretary General
Taxation Society of China
Madam Zhang Yiming – Deputy Division Chief
External Tax Policy Division
General Taxation Bureau
Mr. You Kejie – Deputy Commissioner
Offshore Oil Tax Bureau

Also present will be Mrs. Nellie Fong, Tax Partner, Arthur Andersen, Hong Kong.

These persons will speak and take questions on taxation and investment in the People's Republic of China. They propose to deal in particular with the direction of foreign tax policies; tax ruling requests; taxation of sales activities; deductible and non-deductible expenses; off-shore tax issues; treatment of pre-contract costs; consolidated returns and the relationship between accounting, auditing and taxation.

ITALIAN BRANCH

The Italian Branch of IFA announces that on 21-22 June 1985 it will organize an international tax conference in Rome with the collaboration of 2 Italian tax journals, i.e. the *Rassegna Tributaria* and the *Diritto e Pratica Tributaria*, with the financial support of Banca Nazionale dell' Agricoltura. The conference will be opened by Professor Avv. Bruno Visentini, Minister of Finance, and it will deal with, among other things, the following subjects:

- multinational enterprises and their relationship to taxation;
- multinational enterprises and tax havens;
- tax avoidance and tax evasion;
- status of tax treaties concluded by Italy;
- international aspects of assessment and collection of tax;
- exchange of information and mutual assistance procedure;
- transfer pricing with respect to royalties;
- capital gains, interest and dividends;
- income and cost allocation with respect to service fees;
- foreign tax credit;
- permanent establishment;
- residence for tax and exchange purposes;
- international leasing;
- international aspects of VAT.

SWISS BRANCH

The Swiss Branch of IFA announces that an ordinary meeting will be held on 14 June 1985 in Zürich. During this meeting representatives for the General Council of IFA will be elected. The meeting will further deal with problems concerning the taxation of married couples and of persons who live together without being married. Professor Dr. D. Yersin will report on this subject and Professor Dr. P. Locher will criticize the pilot decision of the Bundesgericht (Federal Court) of 13 April 1984 dealing with the taxation of married couples.

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

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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 to achieve this aim by: a) scientific research; b) holding congresses; c) publications; d) cooperation with other organisations whose objectives are mainly or partly fiscal, especially the International Bureau of Fiscal Documentation in Amsterdam; e) by all other appropriate methods.

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Belgian Coordination Centers Prove Success

By Patrick L. Kelley

The Belgian coordination center legislation, providing major tax incentives for international groups which centralize coordination activities in Belgium, has proven a success. More than 70 applications have so far been introduced and nearly 50 centers have been officially recognized. Of these, about 70% are for U.S.-based multinationals.

In response to this success, the Belgian Parliament has transformed these concessions into a permanent part of Belgian law. The original legislation, Royal Decree 187 of 30 December 1982, allowed only a three-year period for companies wishing to apply for coordination center status. This time limit has now been abolished.

Furthermore, the concessions are now available to management and research centers which were set up prior to enactment of the original incentive legislation. This extension is intended to eliminate any discrimination between international groups which have been attracted to Belgium by the coordination center concessions and multinationals which were already present in Belgium before these rules were adopted.

Other significant changes in the coordination center legislation were introduced by the Parliament in the law of 27 December 1984. Centers recognized under the new law will be subject to a token income tax calculated according to a "cost-plus" formula. This replaces the previous discrimination between coordination centers set up as Belgian resident companies, which were in principle entirely exempt from corporate income tax, and centers established as Belgian branches of foreign corporations, which were taxed on half their earnings upon repatriation of profits.

Belgian coordination centers continue to enjoy exemption from withholding taxes and capital registration taxes. Furthermore, as an incentive to investment in Belgium, interest paid on loans to coordination centers carries with it a tax credit for the lender. Exemption from foreign exchange controls is available to centers which transact most of their operations with non-Belgian affiliates. Finally, expatriate personnel of coordination centers may enjoy personal tax concessions available under other provisions of Belgian law.

BROAD RANGE OF USES FOR COORDINATION CENTERS

Multinationals have found a great variety of uses for Belgian coordination centers. In fact, no two centers are likely to engage in exactly the same combination of activities. The legislation permits each multinational, in agreement with the government, to construct a "tailor-made" coordination center in function of its present and future needs.

This great flexibility in application of the legislation stems from the broad range of activities which are permitted for Belgian coordination centers. All such activities have one thing in common, however. They must be "intra muros", or in other words, performed solely for the benefit of other related companies.

For example, a Belgian coordination center may centralize accounting activities for affiliated companies. It may charge such affiliates for its services, and even recover a profit margin on a "cost-plus" formula. However, the center may not perform accounting services for other, non-affiliated companies which are not members of the group. Performing services for unrelated parties would violate the "intra muros" requirement.

The activities which can be carried out by coordination centers can be separated into two principal categories.

A. Support services rendered directly to group members

The first category comprises a variety of support services provided directly to other group members. Such centralized services make unnecessary the duplication of the same activities in a variety of different locations. This increases efficiency and can result in important cost savings.

Services in this category are normally charged directly by the coordination center to the affiliated companies which receive them. Generally such charges are based on the costs incurred by the center in carrying out the services, often with a small profit margin calculated according to a "cost-plus" formula. The activities which fall into this category are the following:

1. Advertising and sales promotion

Coordination centers may organize advertising campaigns for group members, centralize the purchase or development of sales-related documentation, participate in trade fairs and organize seminars for sales personnel of group members and their customers. The coordination center should not, however, participate actively in the solicitation, negotiation or conclusion of sale contracts with unrelated customers.

2. Collection and dissemination of information

This category covers a broad range of activities, including carrying out market surveys, investigating custom-

Mr. **Patrick L. Kelley** is Chairman of the Legal and Taxation Committee of the American Chamber of Commerce in Belgium and member of the Brussels bar. This article also appeared in *Commerce in Belgium*, May 1985.

ers' credit, collecting information regarding availability of products from outside suppliers, etc.

3. Insurance and reinsurance

A coordination center may centralize the insurance or reinsurance of risks borne by affiliated companies. The coordination center must act on behalf of and in the name of members of the group.

4. Scientific research

Scientific research, as well as product development activities, may be carried out within the framework of a coordination center.

5. Government relations

Relations with national as well as international government institutions may be handled by a coordination center. This activity is of particular interest to multinational groups which wish to develop monitoring and liaison activities with the institutions of the European Communities located in Brussels.

6. Accounting, administrative and EDP[1] activities

A broad range of back-up services for affiliated companies can be carried out centrally at a coordination center. A center may, for instance, prepare and send invoices to customers on behalf of group members, receive and confirm customer orders, organize the shipment of raw materials and finished products, and maintain inventory controls over product flows.

7. All preparatory and auxiliary activities

This is a "catch-all" heading, covering a broad range of activities which are remote from the profit-generating industrial and commercial objectives of the group. Such activities include regional headquarters functions of supervision and control, warehousing of raw materials, parts and finished goods, centralizing of in-house legal services, tax management and the like.

Included under this heading is the activity of centralized purchasing of raw materials and components from third parties. Such purchasing must be carried out by the center in the name and for the account of affiliated members of the group.

B. Financial services provided indirectly through inter-company transactions

The second major category of activities carried out in Belgian coordination centers consists of intercompany transactions whose objective is to centralize financial management and the hedging of foreign exchange risks.

A common feature of these activities is that they are not rendered directly by the coordination center and invoiced as management services to the affiliated companies of the group. Instead these services are carried out in the form of intercompany transactions, such as leasing and factoring. The coordination center covers its costs with revenues from the transactions themselves. Such revenues take a variety of forms (interest, lease payments, etc.) depending on the nature of the particular transaction.

This category of activities represents the most original feature of the Belgian legislation, and has been the focus of the greatest interest from multinationals. The Belgian legislation enables multinational companies to carry out a variety of centralized financing operations in a favorable tax climate and take advantage of Belgium's wide network of double taxation treaties as well as its respected position as a member in good standing of the European Economic Community. The following are the principal techniques made possible by the Belgian legislation for centralized financial and hedging activities.

1. Reinvoicing

A coordination center may reinvoice to affiliated companies products and services invoiced to the center by other members of the group. Such reinvoicing is an effective technique used to manage foreign exchange risks for group members.

An example for this technique is as follows:

Global, Inc. has established a plant for manufacturing component parts in Germany and an assembly plant in the U.K. The German plant invoices the components in German marks on 90 day credit terms.

If the components are invoiced directly to the U.K. affiliate, the U.K. company will bear a foreign exchange exposure between the time it books the account payable and the date of settlement. If the U.K. company also purchases goods and services from affiliates in other countries, it may have similar exposures in a dozen currencies or more.

Likewise, the other affiliated companies of the Global group, each purchasing goods and services from group members, may bear the risk of currency fluctuations. The various affiliates may not have adequate financial expertise or banking facilities to deal effectively with the risks involved.

These currency risks can be concentrated in a coordination center through the technique of reinvoicing. In the example above, rather than billing the U.K. affiliate directly, the German company would invoice the Global coordination center for the components. Since the invoice would be denominated in German marks, the German company would bear no currency risk.

The Global coordination center would then reinvoice its U.K. affiliate for the same products, but in pounds sterling. The U.K. company would thereby be insulated from any risks of fluctuation in the sterling-mark exchange rate prior to the settlement date. The entire exchange risk is concentrated in the hands of the coordination center, along with all similar risks on the multitude of intercompany transactions among group members. A small staff of foreign exchange experts within the center can oversee the entire group's foreign exchange activities.

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[1] EDP = electronic data processing.

2. Factoring

The factoring of receivables is another technique for shielding group members against foreign exchange risks. A German manufacturing company may have outstanding receivables denominated in a variety of currencies. Instead of bearing the risk of exchange fluctuations until payment, the German company may factor its receivables to a coordination center. Since the German company receives immediate payment in its own currency, it is effectively relieved of the exchange risk. The coordination center, which bears the risk, can manage this risk as well as all other similar exposures as part of a centralized program of foreign exchange hedging.

Whereas reinvoicing can be carried out only with respect to intercompany sales, such a limitation does not apply to factoring. Claims against both related companies and non-related customers may be acquired by a coordination center. In application of the "intra muros" principle, however, the center may acquire such receivables only from members of the group.

Factoring also represents a powerful technique for centralized management of group liquidity. A coordination center may effect rapid injections of cash in group members by purchasing a portion of their accounts receivable.

3. Leasing

Leasing is another common technique for centralizing group financing. A Belgian coordination center may lease movable property (machinery, tools, etc.) as well as immovable property (land and buildings) to group members on more favorable terms than may be available to each affiliate standing alone. Coordination centers may even carry out sale and lease-back transactions, subject to compliance with strict guidelines.

4. Financing

A coordination center may loan funds to affiliated companies on a short or long-term basis.

The funds so loaned may be from capital of the coordination center itself. Not surprisingly, some coordination centers have been set up with a capital of 50 million dollars or more. The loaned funds may also be borrowed from banks and other financial institutions or even through the public issuance of corporate obligations. Coordination centers may play an important role on Eurobond markets in years to come.

CONDITIONS FOR RECOGNITION AS COORDINATION CENTER

In order to qualify for the advantages of coordination center status, a number of conditions must be satisfied.

A. International group

The coordination center must form part of an international group of affiliated companies with an aggregate capital of at least 1 billion Belgian francs (15 million U.S. dollars) and annual turnover of at least 10 billion Belgian francs (150 million U.S. dollars). A group is defined to include all companies in which the common shareholdings, direct or indirect, represent at least 20% of capital.

The condition of being international is satisfied if the group comprises at least one non-Belgian affiliate or has at least one branch established outside Belgium.

B. Qualifying activities

The activities to be carried out in the coordination center must be restricted exclusively to those authorized under Royal Decree 187 and enumerated in the decree recognizing the center.

For multinationals which already have management centers established on a taxable basis in Belgium and wish to qualify them as coordination centers under Royal Decree 187, an additional condition exists. This is that the coordination center must introduce new activities not previously exercised in Belgium in addition to those transferred from the existing center. This condition is intended to compensate for the more favorable tax status provided under Royal Decree 187, in comparison to that previously available under traditional "cost-plus" rulings from the central tax administration.

C. Employment requirement

An important condition for coordination center status is that the coordination center must have the equivalent of at least 10 full-time employees by the end of the second year of its operations.

When employees already serving with another Belgian company or branch are transferred to a coordination center, either the coordination center itself or the company from which they are transferred must hire sufficient additional employees to satisfy the requirement of a net increase of 10 additional full-time jobs.

There is no condition as to the nationality or rank of the employees. Furthermore, personnel transferred from an affiliated company outside Belgium are counted toward fulfillment of the ten-employee requirement.

TAX CONCESSIONS FOR COORDINATION CENTERS

A. Company income tax

Under Royal Decree 187 as originally adopted, the income tax status of coordination centers depended upon their legal form. In the case of centers established as Belgian branches of foreign companies, one half of the profits of such centers was subjected to income tax at the time of repatriation. For centers set up as Belgian resident companies, a total exemption from company income taxes was available.[2]

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[2] Such exemption did not apply, however, to non-deductible expenses, directors' fees (tantièmes) or abnormal and gratuitous advantages to the center by affiliated companies.

The Belgian Parliament has now eliminated this distinction between branches and resident companies. In addition, the new law introduces a notional tax base determined as a percentage of certain operating costs borne by the coordination center. The purpose of introducing the notional tax formula was to overcome objections voiced against the original legislation, notably by the Commission of the European Communities, as being contrary to the EEC rules on government subsidies.

The Parliament did not wish, however, to undermine the employment-creating goal of the coordination center legislation. Nor did it wish to interfere with the role of coordination centers as group finance vehicles. For this reason, all personnel costs and financing costs are explicitly excluded from the calculation of the forfeitary tax base.

The percentage to be applied to the remaining costs depends upon the mark-up applied by the coordination center itself in charging affiliated companies for its services. This leaves the discretion to the center itself, within certain parameters, to determine the formula for the forfeitary tax system.

For instance, a coordination center may adopt the principle of charging out its services on a cost-plus 4% formula. If it has total costs of 100,000,000 Bfrs. of which financial and personnel costs represent 80%, the calculation of the tax base would be as follows:

	Costs	*Percentage*	*Tax base*
Financial and personnel costs	80,000,000	0	0
Other costs	20,000,000	4	800,000
		Total	800,000

On the above amount, Belgian company tax will be calculated according to the normal rate, which is currently 45%. In the example, the company income tax would be 360,000 Bfrs. This represents about one-third of 1% of the coordination center's total costs.

The tax base, calculated as shown above, can in no event be less than the sum of certain items identified in the law. These are non-deductible expenses, certain directors' fees (tantièmes), and any abnormal or gratuitous advantages granted to the center by its related group members.

The first two items are normally of little importance to multinationals. Compliance with Belgian tax rules should avoid the treatment of expenses as non-deductible. This means, for example, that the center should not make payments of commissions or other amounts without properly identifying the beneficiary of the payment and the justification for which it is made. Nor should the restriction regarding directors' fees play an important role. Such fees, where granted, normally represent only a small portion of business expenses.

The rule regarding abnormal or gratuitous advantages obtained from other group members is of much more importance. In order to appreciate the significance of this restriction, it is necessary to recall again the original purpose for the Royal Decree 187.

Centralizing of financial and management activities for group members can produce important cost savings. Such savings are shielded from income tax by the favorable rules of the cost-plus system. However, there should be no abuse of these tax concessions by artificial arrangements intended to shift to the center profits properly belonging to other members of the group.

Such artificial transfers of income are prevented by the special rule on "abnormal or gratuitous advantages". The profits resulting from any such transactions which fail to satisfy the arm's length test will be taxable at the normal rate, to the extent such profits exceed the forfeitary tax base.

The impact of this rule may be illustrated as follows. It is assumed that the coordination center considered earlier charges out its services to other members of the group on the basis of costs plus a profit margin of 25%. If the Belgian tax authorities find that 10% of costs is the maximum profit margin which is normal for these kinds of services, the "abnormal or gratuitous advantages" flowing from other group members to the coordination center would represent the difference between 10% and 25%, or in other words 15%.

This excessive percentage would then be applied to the total costs of the center, as follows:

100,000,000 Bfrs. x 15% = 15,000,000 Bfrs.

Since the abnormal advantages as so calculated exceed the forfeitary tax base of 800,000 Bfrs., the larger amount will become fully taxable at the normal corporate tax rate. The resulting tax would be 15,000 Bfrs. x 45% = 6,750,000 Bfrs. By taxing the entire profit or any "abnormal or gratuitous advantages", the Belgian authorities intend to remove all temptations for shifting of profits towards coordination centers through transactions which are not at "arm's length".

In order to reduce possible uncertainties, the Belgian Tax Administration will in appropriate cases issue advance rulings on the maximum percentage mark-up which will be accepted for the charging out of services to group members.

Of course, some very important activities of coordination centers are not charged to affiliates according to any cost-plus formulas. This is so especially with respect to the various activities of financial coordination, such as reinvoicing, factoring, leasing and intercompany financing. It would be difficult if not impossible for a coordination center to fix the terms of a factoring or leasing contract on the basis of a certain percentage of its operating expenses. Furthermore, when these transactions are carried out as a means of centralized hedging against the risk of foreign exchange fluctuations, the financial results for the center will depend heavily upon such fluctuations, which are inherently unforeseeable.

For these reasons, the arm's length character of these transactions would be measured by comparing them to similar operations carried out between unrelated parties. Provided that the terms offered by the coordination center to group members are no less favorable then those applied as between independent parties, no abnormal or gratuitous advantages should result. Of course, this question will have to be taken up with Belgian tax authorities on a case-by-case basis, if an advance ruling on the issue of abnormal advantages is desired.

B. Withholding taxes

The Belgian Parliament has recognized that in order for a coordination center to maximize its role as group financing vehicle, it must be insulated from withholding taxes.

In application of this principle, all payments of dividends, interest and royalties by a coordination center are excluded from application of the normal withholding tax (currently imposed at 25%). A coordination center is also exempted from the withholding tax on real property income.

The legislation also recognizes that coordination centers not only pay but also receive investment income. For this reason, all payments of interest on deposits made by coordination centers with banks and other financial institutions are exempt from withholding tax. On intercompany loans, withholding tax may be avoided in application of existing provisions of Belgian law exempting from withholding payments made to professional investors.

As a further incentive to promote the use of coordination centers, the Belgian law provides a so-called fictitious withholding tax to recipients of dividends, interest and royalties from such centers. The fictitious withholding tax is equal to one-third of the amount of such payments.

In application of this rule, if a bank or other financial institution loans money to a coordination center, it will be able to claim credit for the fictitious withholding to diminish its tax liability on the interest income which it receives. This can be illustrated by the following example.

100	interest received from coordination center	
33.3	fictitious withholding	
133.3	taxable income	
	60	tax (at 45%) before application of credit
	33.3	credit for fictitious withholding
26.7	tax payable.	

This effective tax rate of less than 27% compares with a tax rate of 45% which would normally be imposed on interest income received by the bank or other financial institution. This tax saving can be shared by the lender with the coordination center through a reduction in the effective rate of interest on the loan.

The credit for fictitious withholding on interest is restricted to interest paid on loans used to finance investments in new tangible business assets or research and development activities in Belgium. Such investments or research and development may be carried out either by the coordination center itself, or by any other affiliated group members using funds provided by the center.

C. Capital registration tax

The final but very important tax concession granted to coordination centers relates to the exemption from capital registration tax. This tax, normally imposed at the rate of 1% on capital contributed upon company formation or increases in capital, would represent a serious burden. Coordination centers often require a very large capital in order to carry out their role as group financing vehicle.

Therefore, coordination centers are entirely exempted from this tax. In fact, the registration tax can be avoided even when incorporation takes place before a coordination center is recognized under Royal Decree 187. Such exemption is of course subject to the condition that the coordination center status is subsequently granted.

CONCESSIONS FOR EXPATRIATE EMPLOYEES OF COORDINATION CENTERS

The authors of the Belgian coordination center legislation realized that some expatriate personnel would probably be assigned to coordination centers in order to assure their proper functioning, particularly during the start-up phase. For this reason, the legislation provides to foreign executives and researchers an exemption from the normal requirement to obtain a work permit. Likewise, centers are exempted from the requirement to obtain authorization from the national employment office to hire foreign nationals.

Non-Belgian executives, researchers and other specialists who meet the requirements for non-resident status, under the Administrative Circular of 8 August 1983, are entitled to substantial concessions for personal income taxes.

These concessions consist principally in exclusion from the personal income tax of a variety of expatriate allowances representing the special costs of working and living temporarily in Belgium. Such non-taxable items include cost of living allowances, housing allowances, tuition and home leave grants as well as tax equalization payments. The maximum amount of such exclusions for personnel of coordination and control offices amounts to 1.2 million Bfrs. ($18,500). This ceiling does not apply, however, to tuition allowances or non-repetitive expenses such as relocation and settling-in allowances.

Further concessions are available for coordination center employees who qualify under the Circular and who travel abroad frequently on business. Income attributable to days spent working outside Belgium is not subject to Belgian income tax. Only income attributable to days spent working in Belgium is included in taxable income.

The coordination center legislation does not include any particular provisions regarding social security.[3] Nevertheless, employees of coordination centers can benefit from existing provisions of EEC regulations as well as the U.S.-Belgian agreement on social security.

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[3] Originally, Royal Decree 187 exempted foreign executives and research personnel of coordination centers from Belgian social security. However, it was recognized that in light of Belgium's international obligations, particularly under EEC regulations, such provision was of little practical importance. For this reason, it was abolished by the law of 27 December 1984.

Under provisions of the latter agreement, employees (irrespective of their nationality) sent by an American company to work temporarily at a Belgian coordination center may be exempted from Belgian social security for up to five years, with a possibility of further extensions on a case-by-case basis. Such employees must, of course, remain covered under the U.S. social security system.

EXEMPTION FROM FOREIGN EXCHANGE REGULATIONS

The Belgian–Luxembourg Exchange Institute (commonly referred to as "IBLC") recognizes that exemption from the normal foreign exchange controls greatly facilitates the creation of group financing centers in Belgium. Therefore, the IBLC is willing to grant such centers non-resident status and thereby exempt them from regulation of their transactions in foreign currencies. Such exemption is only granted, however, when the coordination center carries out most of its activities (80% or more) with companies resident outside Belgium and Luxembourg.

PROCEDURES FOR COORDINATION CENTER RECOGNITION

The availability of the concessions provided by Royal Decree 187 is not automatic. These concessions are only granted on the basis of a written request followed by a favorable decision by the Ministers of Finance, Economic Affairs, Employment and Labor and Small Business.

The request for recognition should contain a detailed description of all the activities of coordination and centralization which are intended for the Belgian center. Applicants are encouraged to include even activities which are not planned for the beginning stages of operations but which might be added later on.

The written application is carefully examined by a working group consisting of representatives of the four ministries. Any difficulties encountered by such review, such as vagueness or non-compliance with the legislation, can be discussed with the applicant. If necessary, applications may be revised in order to eliminate such problems.

Once the working group is satisfied that all conditions are met for approval as a coordination center, a formal decree of recognition is prepared for signature by the King and the four Ministers. This decree of recognition constitutes in effect the operational charter for the coordination center during the period it benefits from the concessions of the legislation.

As originally enacted, the incentives of Royal Decree 187 were offered to coordination centers for only 10 years. The legislation, as modified by the Belgian Parliament, still provides for a 10-year period. However, it is explicitly acknowledged that existing centers may apply for a renewal of their status. This means that a coordination center may benefit from the concessions for successive 10-year periods without any maximum time limit.

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The Belgian legislation has proven a success. The years to come will undoubtedly see many more multinationals set up finance, management and research centers in the form of a coordination center. This important development will improve employment opportunities and strengthen Belgium's role as an international business center.

The Treatment of Spouses' Incomes in Schedular and Global Models of Income Taxation[1]

By Sylvain R.F. Plasschaert

1. INTRODUCTION

A perennial and still unresolved normative issue in income taxation is the proper treatment of the family and, more generally, of households composed of several income recipients who live together. When two spouses each earn a net salary, say $ 20,000 and $ 10,000 respectively, should the taxable base consist of the pooled incomes, i.e. $ 30,000, should the tax be assessed on the income of each spouse, i.e. on $ 20,000 and $ 10,000, or should the household be liable to a tax which amounts to twice the tax due on half of their combined net income, i.e. on twice $ 15,000? This latter arrangement amounts to the so-called "splitting method", which takes an intermediary position between the two "polar" solutions just mentioned. Obviously, under progressive rate formulas, the resulting tax liability for the couple, i.e. for the two spouses together, will differ considerably as between the principal alternative arrangements, not to mention the many conceivable variants on these formulas.

In section 2, an attempt is made to disentangle the various threads of this problem, which is so bewilderingly complex that even experts agree only that no satisfactory solution covering all intended objectives is attainable and that less than compromise arrangements must be tolerated. This is due to the fact that, apart from satisfying the predicaments of tax burden distribution according to the "ability-to-pay" principle, it is also commonly proposed that the arrangments adopted should remain neutral, i.e. do not affect the choices between (a) either marrying or remaining single, (b) forming a common household, either as married persons or without being married, or (c) for the second breadwinner (normally the wife) either staying at home or being gainfully employed outside the home.

Still other agreements add to the heat of the debate. Thus it is contended that joint taxation discriminates against the working wife and that even the splitting approach involves the non-recognition of equality for the wife in tax matters. Another consideration, based on economic grounds, is that the very fact that when the wage of the wife is lumped together with that of the husband and then subjected to the marginal rate applicable to the joint income, this "extra-tax" acts as a disincentive for the wife to seek outside employment. Even demographic considerations enter the equation. These could support some degree of preferential treatment of the non-working mother. And finally, this whole area is fraught with societal values and moral considerations such that the question arises whether one should always respect the individual choices of taxpayers even when they may harm the family, considered the foundation of society.

Concern for such "unneutralities", while never absent, has been much more strongly voiced recently. This is no doubt related to an important phenomenon in present-day MDCs,[2] namely the growing proportion of married women who earn money incomes by way of occupations outside the household. The extent to which the situation differs in LDCs is also worth investigating as any significant divergences may suggest different tax arrangements. This aspect is surveyed in Section 3.

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- "First principles about schedular and global frames of income taxation", 30 *Bulletin* 3 (1976) at 99;
- "The definition of gross taxable income in schedular or global income taxes", 31 *Bulletin* 12 (1977) at 535;
- "The definition of statutory net income in schedular and global income tax systems", 32 *Bulletin* 5 (1978) at 201;
- "Schedular and global systems of income taxation: the equity dimension", 34 *Bulletin* 7 (1980) at 287;
- "The treatment of enterprise profits in schedular and global frameworks of income taxation", 35 *Bulletin* 6 (1981) at 261; and
- "The comparatively limited role of income taxation in developing countries", 37 *Bulletin* 4 (1983) at 161.

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[1] A *schedular income tax system* can be described as a system under which each of the various incomes – such as salary, dividends or business profits – derived by the same taxpayer is subjected to a separate tax.
In a *global income tax system* all incomes, derived from whatever source, that accrue to the same taxpayer are taxed jointly, as a single mass of income.

[2] MDCs is a standard abbreviation for "more developed countries", LDCs for "less developed (or developing) countries". Tax designs in each of these two groups are contrasted in Section 4.

To assist in an orderly analysis of the subject, some simplifying assumptions have been made.

(a) Firstly, this study deals only with the "nuclear family", which consists solely of the parents and their children. Other family patterns, such as the "extended family", are mentioned only incidentally.

(b) Generally, the presence of children in the household is abstracted from the study. No doubt the presence of children, in some respects, affects some of the arrangements herein, as, for example, with respect to the "economies of scale" inherent in the common household. However, only rarely do children contribute income to the "nuclear" household; and the effect of dependents on the household's taxable capacity, logically, should be accommodated by reductions of the tax liability of the family, and/or by transfers through the social security system.

(c) Also abstracted are the deductions which are usually granted to the taxpayer and his wife. The concrete shape of such deductions (e.g. whether the non-working wife also qualifies for them) has an impact, which must be taken into account when designing tax rates, for families of different composition and levels of joint income.

2. THE ISSUES

A. Types of households and their taxable capacity

Let us assume that Mr. A and Miss. A′ get married, thus forming family AA′, and maintain their previous employment in which they earn respectively $ 20,000 and $ 10,000. How does the formation of a household, resulting from their marriage, affect their ability to pay taxes?

The household now has $ 30,000 purchasing power at its disposal, more than was available to each of the spouses before their marriage. One may not infer, a priori, that this $ 30,000 should be subjected to a higher marginal and average tax rate, as the comparison is no longer between singles but now between singles and (nuclear) families.

As a matter of fact, (pooled) resources now must sustain two persons, within the same household. On the other hand, their marriage will allow "economies of scale" with respect to a host of outlays both for basic and for less essential consumption. Lodging for two persons proves cheaper, on a per capita basis, than if each of them were living under a separate roof. The "fixed" costs of maintaining an abode and related equipment, such as a kitchen or a car, are spread over two, and no longer over a single person.[3] Besides this economic factor, we note the sociological fact that the incomes accruing to each member flow into a common purse; and outlays by each spouse are made *intuitu familiae,* in that they largely take account of the needs of the whole family. In other words, the members of the househould display a high degree of economic solidarity. Furthermore, spouses are bound in matrimonial law to mutual support. On account of such "consumption economies of scale", the economic well-being of each of the spouses normally exceeds that of a single person earning half of the income accruing to family AA′, i.e. $ 15,000. It follows that under a progressive income tax system, the tax burden on the family AA′ should be more than double that on bachelor C who draws half the total income of family AA′.

The family next door consists of B, who earns $ 30,000, and of B′ who stays at home. It is contended that this housewife B′ performs services, such as cooking or cleaning, which otherwise, as in the case of A′, would have to be provided by outside suppliers and purchased "in the market".[4] This housekeeping represents imputed, non-monetary income, which enhances the real income of the household. Clearly, so goes the argument, couple BB′ possesses more "ability-to-pay" than couple AA′, under the usual *ceteris paribus* assumption, and should accordingly be more severely taxed. The household in which one of the spouses (usually the wife) performs those domestic services generates imputed income, which, furthermore, remains untaxed. In addition, the wage-earning wife incurs costs associated with her outside employment that are not experienced by the wife at home. These extra costs, however, can and should be taken care of by an appropriate deduction, instead of by way of adjustments to tax rates. In contrast to the traditional view, which treats the family as the proper tax subject and draws the inference that the spouses' incomes should be lumped together, the objection is strongly voiced that the position of the married woman is thereby discriminated against. It is also contended that progressive taxes on pooled incomes involve an inducement for the wife to stay at home instead of seeking outside employment. One author, referring to Ibsen's famous play, calls this the "dollhouse effect" (P. Musgrave, 1981 p. 341). Thus, tax arrangements would obstruct what is claimed as a basic right for the married woman to seek outside employment, and, more generally, to exercise full economic and financial autonomy. Along a more sophisticated line of argument, joint taxation is charged with increasing the so-called "excess burden" of taxation. In this connection, the concept refers to the distortion in the choice between (taxed) work and (untaxed) leisure. This distortion is much higher for the wife, as the typical second-breadwinner in the family, whose earnings are subjected to higher marginal rates (P. Musgrave, pp. 346-347). Various studies confirm that the supply of labor of married women is more sensitive to the level of net earnings, and hence to the tax factor, than is the case for the husband (C. Brown, 1981).

And yet, in my opinion, the traditional arguments, fundamentally, retain their validity. Tax law is not bound to faithfully respect the categories of civil and commercial law. The enhanced legal autonomy of married

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[3] Scale economies of consumption are further enhanced when the "fixed costs" of running the household are spread over additional persons, such as children. The fixed costs, though, are not invariable to the size of the household. It is less frequent for a 5-child family than for a childless couple to live in a flat – unless impecuniosity leaves no other option.

[4] For a spirited description of the housewife's tasks as an occupation, see B, Bergmann, 1981, pp. 81-86.

women cannot negate the fact that the formation of a common household has implications on income streams and costs of living of each of its members and, hence, on the "ability-to-pay" (taxes). In fact, a major thrust of progressive, global income tax consists in acknowledging the relevant circumstances that shape the taxpayer's economic life; the couple's common household is one amongst them.

The recognition that housekeeping by the non-working wife enhances "ability-to-pay" also remains valid, in essence, but due to significant changes in life-styles in MDCs, it no longer carries the same weight as previously. In middle class households in MDCs, nowadays, modern facilities such as dishwashing machines or precooked food have become commonplace. They substitute for labor inputs. Hence, under the pooling approach, two-earner families are less discriminated against than previously. As we have mentioned elswhere (Plasschaert 1977), this type of imputed income also raises almost insuperable problems, taxwise. Should one equate the "imputed income" with the number of hours devoted by the housewife to the household to a notional wage? Or, in a somewhat more sophisticated way, look at the savings thus achieved, by comparing the production costs of the household services with the higher outlays needed to secure them from outside suppliers? To my knowledge, no tax system has attempted to openly estimate this imputed income and to bring it within the taxable base. But, in a more covert way, the value of services performed by the wife is sometimes, to an extent, taken into account by way of differentiations in tax burdens according to the constellation of the family (e.g. when the non-working wife does not qualify for a personal deduction).

To account for the above differences in taxable capacity between the couples AA′ and BB′ and bachelor C, some normative yardsticks for tax design purposes can be devised. They will be imperfect, if only because, besides the horizontal equity standard of treating equals on an equal footing, discussed up to this point, criteria of vertical tax burden distribution between "rich" and "poor" cannot be overlooked. However, no unassailable method exists that would scientifically mete out tax burdens in "cardinal" or absolute terms between taxpayers, in the light of differences in taxable capacity.

Yet, the problem is capable of an acceptable solution by way of an "ordinal" ranking of various household profiles. Thus, from the above discussions, it follows that the average tax burden should increase as one moves from (i) the $ 15,000 bachelor to (ii) the two-earner $ 30,000 AA′ family and (iii) the one-earner $ 30,000 family BB′ to (iv) the $ 30,000 bachelor. Such variation in average burdens, in fact, implies the use of progressive rate formulas. Some countries, amongst them the United States, attempt to implement some of those differentiations by way of specific sets of progressive rates for various types of households.

B. The search for adequate tax formulae

The above analysis of the "ability-to-pay" of families with the same overall monetary wage income (and, of bachelors, with the same, or half, that income) provides useful guidelines. It, offhand, raises the question of which technical devices can be used to achieve the desired results. A complicating factor derives from the search for formulae which would remain neutral as to the choice of marital status.

The main technical approaches were mentioned in the first paragraph of this study. The first consists in the *joint taxation of the incomes of the spouses.* It is based on a view concerned principally with economic solidarity, if not unity, of the persons forming a common household, since all net incomes of the spouses confer spending power and, hence, ability to pay income taxes. While seemingly quite logical, this arrangement presents a number of drawbacks. First, as mentioned, there is the vexed question of the value of the housekeeping services of the non-working wife. Second, the pooling approach implies a "penalty on marriage" for those spouses who were gainfully employed before marriage. The formation of a common household no doubt enhances the taxable capacity of each of the spouses. But cohabitation without being married would convey similar "economies of scale" in consumption without being hit by higher progressive rates.[5]

The opposite approach consists in *separately taxing* the net earnings of each spouse. This would nullify the temptation to evade the "penalty on marriage" just mentioned. But, in turn, it suffers from several drawbacks. First, its philosophy is based on an individualistic view, which is not quite compatible with the very essence of marriage or even of unofficial cohabitation between two persons of opposite sex. It also negates the common spending pattern, and the associated economies, deriving from a common household. Besides, the outcome from this "individual base" approach entails some undesirable deviations from what the "ability-to-pay" standard would suggest. The separation formula may involve an excessive favoring of the two-earner family AA′ as opposed to the single-breadwinner family BB′ with the same overall income. The concrete result, obviously, depends in part upon whether or not the extra costs of outside employment for the two spouses is taken into account, taxwise, and how one treats the imputed income from housekeeping in family BB′.

Moreover, liabilities would also differ amongst two-earner families in which the same overall income is contributed by the spouses in different proportions. Under progressive rates, the resulting combined tax burden on the two spouses is likely to diverge rather perceptibly depending on whether each spouse contributes half of that income or respectively 70% and 30%. The tax burden on the family would then depend on the vagaries of the relative contribution of husband and wife to the overall income stream – an outcome which is devoid of logic.

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[5] J. Kay and M. King are of the opinion that "the present British tax and social security system encourages the poor to cohabit, those on average income to marry and the rich to get divorced" (1980, p. 204). Some legislation allows the tax officials to tackle "false" households but the effectiveness of such provisions is doubtful.

So far, the examples discussed only concern incomes from labor or individual businesses. If the "individual base" approach were applied to all incomes, whatever their nature, another serious problem would arise. Let us imagine family DD', in which D is the recipient of $ 20,000 in wages and D' of $ 10,000 in property income. The total cash income equals that of the families AA' and BB', described above. If the property income were to belong to the husband, who also earns the income, separate imposition on yields from capital would invite artificial reshuffling of non-earned income amongst the spouses in order to soften the impact of progressive rates. For that reason, tax statutes tend to restrict the principle of separate imposition to earned income only. Property incomes are typically lumped together. This procedure is reinforced by the fact that a number of countries view property contributed by either of the spouses as "community", or jointly-owned, assets.

Between these two extremes, various compromises are conceivable. The more usual one is the *splitting system* (already mentioned) which can be viewed as a variation on the more generic concept of the *quotient system* whereby the sum of the incomes of various persons is divided by a given quotient. The resulting liability per person is then multiplied by that quotient.[6] The splitting system generally displays a 50-50 pattern, i.e. the quotient stands at 2. When, as is most often the case, marginal progressive rates rise fairly regularly, the 50-50 formula involves a maximum tax reduction, when reference is made to the joint taxation approach.

Splitting equalizes tax burdens between two-earner families, which enjoy the same overall income, irrespective of the contribution of each spouse. By the same token, it renders unprofitable any intra-spouse reassignment of property income. But it has some drawbacks in terms of both horizontal and vertical equity standards. In comparison with the unmitigated pooling approach, splitting will be of more benefit to family BB' (one breadwinner with the wife at home) than to family AA' (two wage earners). Yet it is, as mentioned, generally agreed that the latter has somewhat less taxable capacity even if the actual expenses related to the second-breadwinner's job are taken into account. The splitting approach generally also favors families over bachelors as taxable capacity of a family exceeds that of a single person with only half the family's income. Splitting, as compared to the pooling arrangement, involves a higher reduction of average tax burdens, both relatively and absolutely, as one moves up the income pyramid. With rising marginal rates, splitting the taxable base of a family's overall income of, say, $ 50,000 will involve a relatively higher decline in the tax burden than in the $ 30,000 case.

The debate often suffers from confusion. The "excess burden" argument, for example, as Suphan Andic notes (1981, p. 13) in response to Peggy Musgrave, is not basically due to a discrimination against women, as such, but to the fact that, in the two-earner family, the wife usually is the second breadwinner. Hence, the option "at the margin" to enter or not to enter the job market normally concerns the wife. Andic also makes the highly relevant point that much of the criticism against tax arrangements, and more particularly against the joint taxation scheme, is directed at the wrong target. "All that should be questioned is the progessivity of the tax" (Andic, 1981, p.13). Indeed, when the taxable base expands as a result of pooling of the incomes, the average tax burden rises more than proportionately.

The variety of detailed arrangements in actual tax statutes in MDCs is fairly large (see e.g. Andel, 1980). All in all, there has been a move away from the unmitigated system of joint taxation as far as earned income is concerned. Property, or unearned income, however, has usually remained pooled. This shift reflects the near impossibility to devise an arrangement that would satisfy all dimensions of the problem. Often, the taxpayer can exercise an option between joint or separate taxation. Additionally, claims for a reduction of joint taxation of earned incomes, voiced by the growing number of married women that enter the job market . . . and by their husbands, are a factor to which legislators pay particular attention. Those couples possess extensive voting power, indeed.

3. RELEVANT SPECIFIC FEATURES OF DEVELOPING COUNTRIES

An overview of the inconclusive debate about the proper tax treatment of the incomes of spouses clearly carries a "rich country" connotation, with their large middle classes and high participation rates of married women in outside employment. The question then arises whether in LDCs the occupational and social status of married women is likely to be substantially different and whether this is equally reflected in divergent tax arrangements.

No uniform situation can be expected to prevail throughout the variegated Third World. On the whole, however, the following facts appear to differentiate LDCs from MDCs:

- In LDCs, women enjoy, on the whole, a much lower social status, as reflected in such indicators as the scolarity ratio. Their autonomy in economic matters is also usually more restricted.
- The involvement of married women in outside employment in the modern sector, while growing, is distinctly much lower than in MDCs.
- The occupational structure in LDCs is obviously quite different from that in MDCs. Most often, the majority of the people are engaged in agricultural pursuits although there are cases, as in traditional African agriculture, in which wife and husband perform distinct roles and each of them largely appropriates the fruits of his or her own work (A.M. Kamarck, 1967, p. 103-104). On the whole, the basic fact remains that all their work is performed within the same agricultural unit. To the extent such units are effectively subjected to income taxa-

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[6] This is the well-known "family quotient" system, applied in France and some francophone countries in Africa. The larger the number of dependents living within the household, the higher the quotient. In such a system, understandably, no deductions for dependents are granted.

tion, it would be administratively very arduous and economically rather meaningless to individually apportion, taxwise, the contributions of wife and husband.

- In LDCs, "extended families" are still a major vector of kinship relationship and of mutual support. Thus, the Hindu undivided family "consists of all male Hindus descended in the male line from a common ancestor, their wives and unmarried daughters. The control of the family rests in the Karta who is usually the eldest male member (World Tax Series, India, p. 38). In some other countries, as in India, the undivided family" is still considered as a tax subject. The pooling of incomes then extends to all members of that family.

Given such factors, one would expect that tax laws in LDCs would clearly emphasize joint taxation of the earnings of wife and husband. While information on this matter is not quite comprehensive, one readily notices, however, that in many LDCs, even amongst the poorest, the earnings of the wife are treated separately, or an option to that effect can be exercised. Papua New Guinea, Somalia, Sudan and Sri Lanka can be cited as examples. A full explanation of this state of affairs would require an involved analysis which cannot be attempted here but some possible hypotheses can be plausibly listed. First, tax laws in LDCs often imitate the legislation of an MDC, which was imposed or adopted as the model. Second, one must not overlook that outside employment by married women is still a restricted phenomenon, which is essentially located in the modern sector. This is basically the segment of the population to which the income tax caters. Employed women will most often belong to well-educated and comparatively wealthy urban families that may wield strong political power. Finally, as L.Muten (1975, p. 16) notices, there are societies in which women carry substantial economic weight, as is the case in the commercial sector in Ghana.

4. COMPATIBILITY WITH SCHEDULAR AND GLOBAL INCOME TAX PARADIGMS

Is the separate or the joint taxation of spouses' incomes – or some intermediary hybrid formula – compatible with the two types of income taxation that are the central concern of this study? The answer to that question, in my opinion, is rather complex.

If a schedular system were applied in pure form according to the purpose for which it was originally designed, i.e. to discriminate amongst tax burdens according to the nature of the sources of income, each of those incomes would be subject to a different, but flat rate. In other words, in principle, different sources would be taxed separately. In this connection, it is worth stressing that the separate approach focuses on the production of the incomes, not, as in the pooling formula, on the subsequent spending of income. The schedular system, itself, is also predicated on the origin of taxable incomes.

It should even be, in terms of the resulting tax liabilities, immaterial whether each spouse is taxed separately or jointly. As explained in Section 2, the progressive rate curve is the main reason why the tax treatment of the married couple raises intractable problems of tax design. In a schedular setting, the nature of the particular income enjoyed by the couple should be the decisive factor, not whether a particular income flows to an individual or to a household. Administrative considerations should almost certainly determine whether the tax on a given income, accruing to a member of a household, is to be charged to the household or to the spouse concerned. Thus, earned incomes could be readily taxed at source and debited to the recipient spouse whereas the profits from non-corporate business and agricultural production units could be imposed on a joint basis, as it would be too intricate and unwarranted to distinguish what share in the profits is attributable to each spouse.

In actual life, however, no such pure schedular system any longer exists. The schedules of labor incomes, both those resulting from salaried occupations as well as from self-employment, have typically become equipped with "personalization parameters" such as deductions for dependents and some elements of progressivity. The need to acknowledge differences in taxable capacity has apparently become compelling. The household, in which spouses live with their dependents, then becomes the logical choice as the tax unit. Such considerations also justify a joint return, if only because this is a convenient way to record all the facts, such as the number of dependents, which permit the personalization of tax liabilities.

5. CONCLUSION

These comments about semi-personalized schedular systems, *a fortiori*, support the view that a joint imposition of the spouses' incomes is a congenial attribute of global type income taxes. These latter are indeed predicated upon the principle of differentiating tax burdens according to comparative taxaxble capacities. This standard refers to the standard of living which taxpayers can obtain with their freely disposable income. Joint taxation would account for the factors that increase such "ability-to-pay" taxes, whereas deductions provide tax relief, on account of the claims which dependents make on the overall income of the household. The resulting net taxable income of the household is then subjected to progressive rates. The heavy extra burden, which the pooling of incomes may imply, however, has led governments to significantly reduce the joint taxation format. When the separate taxation of earned incomes is imposed, or left as an option, tax statutes, in fact, introduce a schedular stone in a global type building, thus weakening the impact of the "ability-to-pay" standard. But shifts in societal values may force infringements on the basic principles that uphold tax systems.

Substitution of proportional rates for progressive ones would no doubt considerably simplify matters. Even then, however, some problems would remain. First, the fact that the imputed, non-market income of the housewife is not brought within the taxable base would imply a relatively favorable treatment of such one-earner households. Second, some solution would have to be devised for differences in taxable capacity between singles and married couples. But, on a more fundamental level, a global tax with flat rates, while *technically* feasible, would no longer be compatible with the tax *doctrine* which underlines those systems, i.e. to distribute income tax burdens according to the relative taxable capacity of the relevant tax units. Such an objective clearly requires progressive rate formulas.

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NIGERIA:

Analysis of Some Tax Issues in the 1985 Federal Government Budget

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I. INTRODUCTION

The policies pursued in 1984 fiscal year by the present Federal Military Government were a revision of the ousted civilian government's budget. A number of stringent measures were introduced in the revised 1984 budget aimed at drastically cutting down on government spending, imports, and foreign exchange deficiency. The measures were too austere for everybody, nonetheless they were effective in holding back the downward economic trends which characterised the ousted regime.

Although the recession which started about four years ago is very much with us, the 1985 budget is aimed at launching the economy on the path of recovery. In order to make this feasible, "our achievements in 1984 have to be sustained and improved upon. . .".[1]

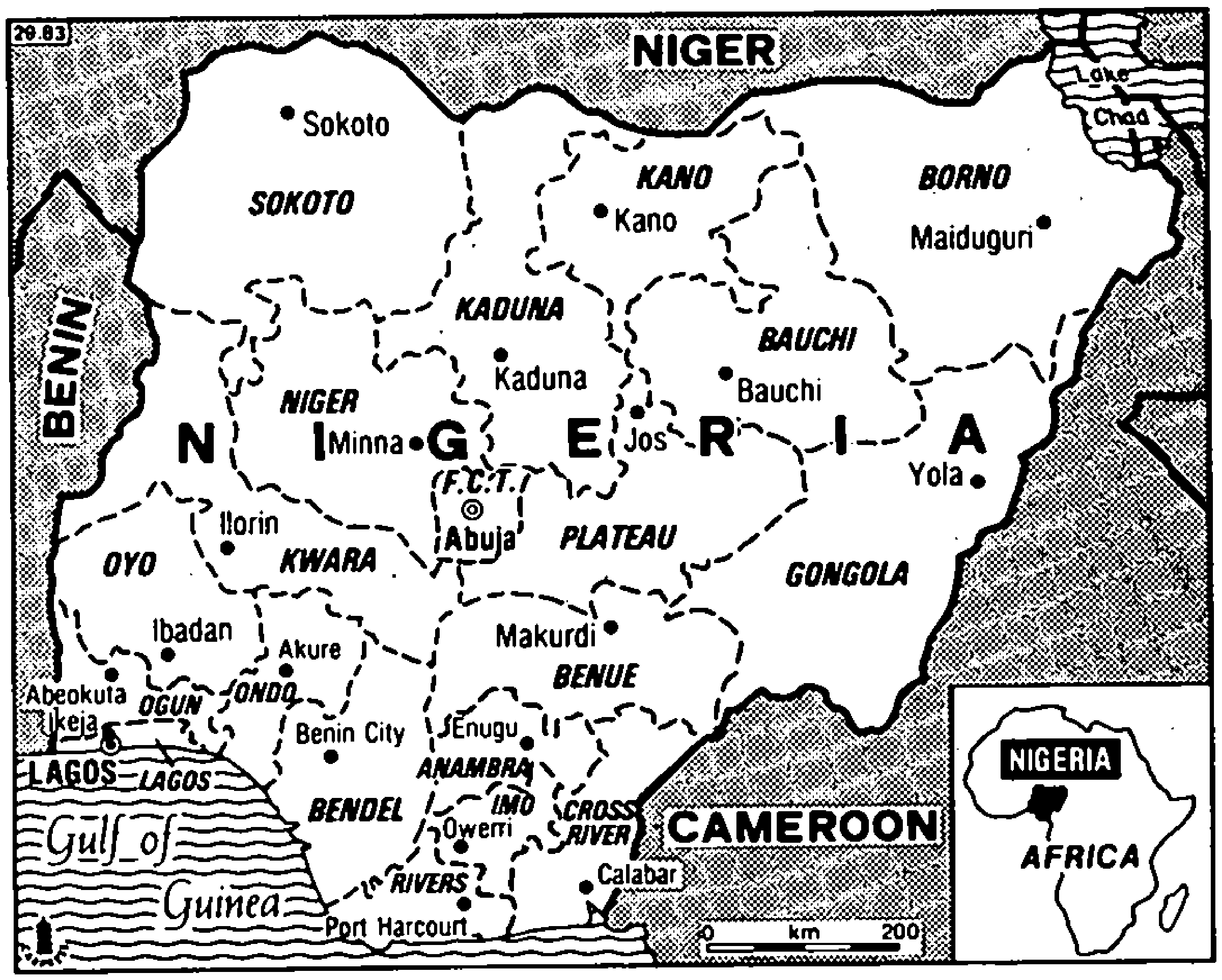
A number of fiscal measures as well as monetary and credit policies have been proposed in the 1985 budget in order to revive the economy. Some of the proposals will have some tax implications. In view of the fact that tax proposals in any Budget Speech are usually regarded as the core, and also stimulate the interest of many, these comments will be largely confined to an attempt to highlight and, where possible, consider and analyse some of the elements in the 1985 Budget Speech that bear directly or indirectly on taxation.

II. BROAD TARGETS AND OBJECTIVES OF 1985 POLICIES

Any effective attempt at an evaluation of the tax proposals in the 1985 Budget can only be done against the background of the broad targets as well as the major monetary and credit policy objectives aimed at in the 1985 Budget.

The beauty of the 1985 Budget is that it quantified the main targets aimed at. These, according to the Minister of Finance,[2] include:

(a) 1% growth rate in Gross Domestic Product (GDP);[3]
(b) a 200 million naira increase in external reserve;[4]
(c) a rate of inflation of 30%.[5]



These quantitive targets are predicated on the objectives of the monetary and credit policies for 1985 which are,[6] among others:

(i) To accelerate agricultural production, especially food and raw materials,
(ii) To stimulate industrial production thereby reducing dependence on imports,
(iii) To reduce the rate of price inflation,
(iv) To achieve a healthy balance of payments position, and
(v) To increase and mobilize domestic and external financial intermediation and capital formation.

III. SOME TAX ISSUES ANALYTICALLY EXAMINED

There are quite a few tax proposals and other issues with tax implications in the 1985 Budget, some of which may have far-reaching effects.

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1. Major-General Muhammadu Buhari, 1985 Budget Speech.
2. Dr. O.O. Soleye, Statement on the 1985 Budget.
3. At the 1977/78 factor cost, the GDP had declined by 5.3%, 2.2% and 4.6% in 1981, 1982 and 1983 respectively. Despite recorded improvements in the petroleum and agricultural sectors there was no increase in the overall GDP in 1984 due to declines in industrial and other sectors. (See Central Bank of Nigeria Credit Guidelines for 1985 as reported by Eseinune Mojaye, *Business Concord*, 11 January 1985.)
4. 1 Naira = (approx.) US$ 1.1341 or £ 0.8844 (9April 1985).
5. Nigeria's rate of inflation increased by as much as 16.2 percentage points to stand at 40% during 1984 as against the 23.2% of 1983 and the 7.7% of 1982. (See also Eseinune Mojaye, *Business Concord*, 11 January 1985.)
6. Op.cit. Statement on the 1985 Budget.

A. 1984 Fiscal measures brought forward to 1985

Some of the measures introduced in the 1984 fiscal year are to be continued in 1985.

A major one has to do with some of the basic changes in the Customs and Excise Tariffs structure which came into effect via Decrees Nos. 24 and 25 in May 1984. The main purpose of these fundamental changes in the Customs and Excise Tariffs was "to create greater harmoney and stability in the tariff and to expand the base of excise duty."[7] Although the Decrees introducing these changes do not envisage changes within 3 years of operation, Government is, however, of the opinion that it is rather too early to assess the full impact of the measures on the economy. Nonetheless, their effects on the economy will be closely monitored by the government with a view to having good ground for effecting desirable changes.[8]

The other measures which were brought forward to 1985 from the 1984 fiscal year include:

(i) The basic travel allowance (BTA) of ₦ 100 per annum per person of the age of 16 and above.

(ii) Strict enforcement of the regulation making it mandatory for visitors to pay their bills in foreign exchange.

(iii) Personal home remittance for expatriates to remain at 25% of their basic salaries.

(iv) Placing of all import items (except prohibited goods) under specific import licence and tying of the import licence issued to the foreign exchange budget.

(v) Abolition of the compulsory advance deposit (CAD) requirement for imports into Nigeria to facilitate importation of essential goods.

These measures have some positive effects on the broad targets and objectives aimed at in 1985. For instance, policies (i) through (iv) will have positive effect in the external reserve position while (v) may help to stimulate production. However, the pegging of home remittances for expatriates at 25% of their basic salaries may hinder production by acting as a disincentive to the much-needed foreign expertise in our industrial sector. Also the restrictions on import licence which may lead to a healthier balance of payments position may kill the spirit of entrepreneurship and hamper production. Any policy that hampers production will reduce revenue accruing to government through income tax, profits tax, excise duty and import duty.

B. Advance payment of customs duty

An innovation in the country's revenue collection system introduced in the 1985 Budget is an advance payment of customs duty. This scheme whose effective date is expected to be 1 April 1985[9] involves the payment of import duty at the time when letters of credit are opened. It abrogates the present practice of collecting import duty when the goods have arrived. The official reason for the new arrangement is to eliminate, as much as possible, the abuse and lapses to which the previous procedure for the collection of customs duty from importers had been subjected. Some of the anticipated *advantages of the scheme* include:

(i) Making it easier for genuine businessmen to collect their goods at the ports with minimum delay.

(ii) Reducing the number of people who will be applying for import licences.

(iii) Stopping fly-by-night importers.

(iv) Reducing the premium on import licences, i.e. discouraging those who trade in import licences.

(v) Giving the customs officials the opportunity to prove their honesty.

(vi) Reducing the level of imports thereby improving the current account position.

(vii) Improving the cash flow position of government.

The above advantages (i) through (v) may not be sustained on solid ground. The most important merit is the improvement of the cash flow position of government, particularly with respect to time value of money. But this is not without a cost to the economy as a whole. The advantage to the government is counter-balanced by a corresponding disadvantage to the businessman whose cash flow position will be adversely affected. This will amount to robbing Peter to pay Paul.

Among the canons of a good tax are ease of collection and the economy of administration. Depending on other circumstances these considerations may far outweigh other factors. It has been claimed that the new scheme will make for ease of collection of customs duty, and may improve revenue prospects of government, especially as chances of under-payment would be minimized. However, doubts have been expressed about the bank's ability to administer the new policy and interpret customs tariff regulations. Apart from creating additional cost to the bank, it is feared that by this arrangement, "government could unwittingly be creating a new avenue *for corruption to thrive*".[10] Besides, the assumed convenience in collection under the new scheme is again contravened by the inconvenience, in time and manner, of payment to the importers. This is contrary to the canon of convenience with respect to the taxpayer.

Again, the supposed advantage that it would reduce the level of imports, thereby improving the balance of payment[11] position may be real only to the extent that it discourages non-genuine importers. Otherwise, if this is achieved as a result of its disincentive effect on genuine importers, the scheme will be deemed counterproductive because of its negative effect on the economy as a whole.

It is believed that under the previous procedure some corrupt customs officers exploited all sorts of loopholes and colluded with smugglers to defraud Nigeria of substantial revenue. Unless it is assured that all the

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[7] 1985 Budget Speech.

[8] Dr. O.O. Soleye, op.cit.

[9] Osy Onyenwe, *Business Concord* (Lagos: Nigeria) 15 February 1985.

[10] Chief J. Akin-George as quoted in *Business Concord* (Lagos, Nigeria), 4 January 1985.

[11] The Federal Military Government wants to improve on the performance of previous years by further reducing the level of current account deficit through prudent foreign exchange management. The balance of payments deficits in 1984, 1983 and 1982 were ₦ 102 million, ₦ 245 million, and ₦ 1,398 million respectively.

loopholes are plugged, a change in modus operandi may not turn a corrupt member of the society into a saint. The new scheme may be perfect in design, but the execution may corrupt its perfection.

It is undeniable that the new policy shift will create a number of difficulties for the importer, which difficulties may affect incentive to enterprise. This in turn may lead to low productivity, higher inflation rate, more shut-down of plants and retrenchment of the work force, distortion of free market policy, and under-utilization of human and economic resources. For instance, the payment of *import duty in advance* is a strain on the meagre resources of the Nigerian businessman.

It will tie down his scarce working capital for a long time before the arrival of the imported goods, and will unnecessarily increase the cost of doing business in much the same way as the Compulsory Advance Deposit (CAD) scheme which was abolished in May 1984 by the same administration that has introduced the advance customs duty. It will also lead to loss of the Government's projected revenue due mainly to reduced income tax, profits tax, customs and excise duties occasioned by idle capacity and retrenchment of the labour force. When considered against the background of the objectives of the monetary and credit policies for 1985, it becomes clear that while the new scheme might lead to an illusory healthy balance of payments position, it will at the same time fail to (a) give the desired stimuli to industrial production so as to reduce our dependence on imports of finished goods, and (b) reduce the rate of price inflation. In addition it will make any thought of reduction of mass unemployment (which, unfortunately, is not one of the objectives or targets of the 1985 budget) a mere delusion.

It is also pertinent to note that the fact that a letter of credit is opened does not guarantee that the delivery of the goods will go through. The order may be terminated by one of the parties for one reason or another. The goods may be despatched but not received due to accident, enemy action, or pilferage. This will raise a problem of refund of already paid import duty which creates its pressure on management and on the cash flow position of government.

C. Special levy on air travel

One of the new measures introduced in 1985 Budget as part of the government's efforts to increase revenue is the ₦ 100 levy on air tickets for journeys outside Africa. The levy, which took immediate effect, is motivated by the need to generate additional revenue and not by the desire to discourage the passion for travelling outside Africa among Nigerians. The levy, which is already yielding a bumper harvest, is estimated to earn at least ₦ 52 million every year.[12] Within 72 hours of the new levy coming into effect about ₦ 500,000 had already been collected from the three international airports in Lagos, Kano and Port Harcourt.[13]

The levy is in addition to the existing airport tax [14] of ₦ 5 per adult and ₦ 2 per child. The new levy exempts infants and diplomats, and includes those who had already purchased their tickets in advance of the new measure, but which they had not utilized.

With the introduction of the ₦ 100 special tax per ticket on all international travel to places outside the continent of Africa, Nigeria has become the 70th country in the world to impose such a levy on air travel.[15] The levy varies from country to country in terms of nomenclature and amount payable. Some are based on a fixed percentage of the value of the ticket while others are a flat rate. In many countries this levy is restricted to residents only; while in some the tax is applicable irrespective of whether the ticket is purchased from within or abroad.

One conceptual drawback of this levy as it applies to Nigeria is the imposition of a flat rate on all foreign travel outside Africa. The flat rate concept tends to negate the belief that the purpose of the levy is for revenue generation. It rather leaves the impression that government views all such foreign travel negatively or sceptically, and needs to discourage it. Otherwise one would expect that equity, which is an attribute of a good tax, should have been brought to bear on this. The levy, as a revenue generating measure, could have been predicated on the ability to pay principle so as to make it equitable. It is inconceivable to tax two tickets costing ₦ 500 and ₦ 2,800 equally. Tax differential could be injected into it, either by graduating the levy according to cost of the ticket, or by drawing a distinction between business and non-business trips. In the latter case, business trips will attract a higher air ticket tax than non-business journeys. This is because the incidence of air ticket tax on a business trip is shiftable while the burden of the tax on non-business trips may not be shifted. Besides, while some of the non-business trips can be avoided, most of the journeys undertaken for purposes of business cannot necessarily be avoided.

On the implementation of the ₦ 100 levy it has been suggested that the Federal Board of Inland Revenue would issue in advance to airlines and booking agents operating in Nigeria, receipts/tickets in booklets, duly paid for in advance, at the rate of ₦ 100 for a receipt or ticket, and that the outlay on the booklets would be recouped from subsequent sale of receipts or tickets to their customers.[16] This means that both the point of impact and the responsibility for collection are on the airlines and the booking agents.

To pass the buck this way does not make for fairness. Although the incidence of the tax will eventually pass to the customers, this procedure will not only increase the administrative responsibility of the airlines and the booking agents, but will also tie down their working

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[12] Nsikak Essien, *Business Concord* (Lagos, Nigeria), 11 January 1985.

[13] Bennet Obikwelu, *Daily Star* (Enugu, Nigeria), 7 January 1985.

[14] The airport tax is in operation in 109 countries of the world, including Nigeria. See Eseinune Mojaye, *Business Concord* (Lagos, Nigeria), 11 January 1985.

[15] Ibid. – The other countries where such levies on air travels exist include Peru, Bolivia, Sierra Leone, Algeria, Bangladesh, Cape Verde, Portugal, Iran, Thailand, Guyana, Zaire, Nicaragua, Zimbabwe, Egypt, Barbados, El Salvador, Guatemala, Japan, Liberia, Taiwan, Kampuchea, Ghana, Costa Rica, Sudan, Panama, and Argentina.

[16] Omafume Amurun, *New Nigerian* (Kaduna: Nigeria), 5 January 1985.

capital in this era of extreme austerity. In order to make the burden lighter, the airlines and the booking centres should be given the responsibility for collection while points of impact and incidence should be on the users of the air tickets. This means that government would have to issue the receipts to the airlines without requiring immediate payment. The airlines would then pay up when the levies were collected, at the time of sale of tickets. In this way government would not take credit for levies on tickets not actually sold.

D. Pre-operation levy on dormant companies

Another measure introduced in the 1985 Budget to increase revenue is the pre-operation levy of ₦ 500 per annum on dormant companies. The levy is to be imposed on registered companies which, after six months of incorporation, fail to commence business. The levy would remain effective for as long as the company remains dormant. Apart from its revenue generation potential, the levy may be effective in reducing the volume of corruption associated with some people owning several companies which they declare dormant every year, but which they use as avenues for engaging in fraudulent and doubtful business activities.

However, as a blanket measure encompassing all dormant companies, it may not be fair to some genuine small-scale industrialists who may have good reasons, rather than fraudulent intentions, to remain dormant for a while after incorporation. For example, there may be an unnecessary delay from the Federal Ministry of Industries to approve the location of the company. There may also be delay in approving import licences for machinery and equipment and another delay in getting foreign exchange approval. All this ought to be taken into consideration before declaring a company dormant for the purpose of the pre-operation levy. Otherwise, this levy may so frustrate some genuine entrepreneurs that they may be forced to find illegal means of getting over the hurdless created by government agencies. This may, in the long run, cost the government more, both economically and socially.

E. Allocation for imports of visible goods

The inflow of our foreign exchange in the 1985 fiscal year, arising mainly from oil and non-oil exports, services and capital, is estimated to be ₦ 8.024 billion. Out of this, ₦ 8.00 billion will be applied to debt servicing and to importation of goods and services as follows:

	₦ (in billion)	%
(i) Repayment of loans[17]	3.5	44.0
(ii) Import of visible goods	3.15	39.0
(iii) Import of invisible goods	1.15	14.0
(iv) Contingencies	0.20	3.0
Total	8.00	100.0

(i) Poor stimulus to the industrial sector

The belief is rife that the allocation for import of visible goods in 1985 is grossly inadequate while the allocation for external debt servicing is unnecessarily high within the context of our present state of depressed economy.

The implications of the inadequate allocation for import of visible goods such as industrial raw materials, machinery, spare parts and completely knocked down (CKD) goods are overwhelming. In the first place the productive sector cannot be effectively stimulated. Our economy is depressed, and it is hoped that with the targets and the objectives set in the 1985 budget the economy will start to recover. The projections therein, if achieved, would mark signs of recovery. But they are, unfortunately, utopian because we cannot expect to reap where we do not sow. The budget indicates a curious paradox in respect of the productive sector. The projected 1% growth in GDP and a reduction in the inflation rate are based on unjustified euphoria. The first step to recovery is to sufficiently stimulate the productive sector. There are signs of recovery only when the level of business activity – measured in terms of level of employment, GDP, rate of inflation, and per capita income – rises. But this can hardly be the case with the inadequate allocation for importation of visible goods. The year 1984 was bad enough for the industries whose foreign exchange requirements were not met even 50%; 1985 may be even worse. The poor stimulus to industries will lead to closure of more factories, more unemployment, increased scarcity of consumer goods, increase in the rate of inflation, and other attendant social evils. The adverse effect of this on internal revenue due to reduced income tax, profits tax, withholding taxes, and excise and import duties will make the projected revenue of the government unreal.

Besides, the poor stimulus given to the industrial sector may render counterproductive the boost given to the agricultural sector in the Budget. This is because the factories may not remain open to utilize and further process some of the output from the agricultural sector.

(ii) Commitment to external debt servicing

Apart from the reduced foreign exchange earnings, the main reason for the inadequate foreign exchange allocation to the industrial sector is the government's overcommitment to our external debt servicing. There is a phenomenal increase in the debt service ratio in external accounts from 25% in 1984 to a projected level of 44% in 1985. The reason for the commitment to debt repayment is for Nigeria to re-establish credibility and regain her lost image of creditworthiness in the eyes of the world. This is laudable in one sense. But when weighed against the opportunity cost of our foregone immediate industrial revival which would bring our depressed economy on the path of recovery one tends to question the laudability of our high degree of commitment to debt servicing. It is not a choice damaging our international reputation and leaving our economy in the clutch of deeper depression. It is also not a matter to be subjected entirely to the dictates of political judgment on priorities or to budgetary feasibility. It is rather a matter of a well chosen policy mix of re-establishing and maintaining some credibility and of effectively putting our depressed economy on the path of recovery by sufficiently stimulating our industrial and agricultural sectors.

It is wrong for a country to handcuff itself, or impose

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[17] In 1984, 25% (amounting to ₦ 2.63 billion) of our total foreign exchange earnings was applied to external debt servicing.

undue hardship on its economy, all in the name of debt servicing in order to redeem credibility. Our strategy for a better future should be built on the realities of today and the lessons of yesterday. The key to our recovery lies in raising our productivity and promoting our human development. This is true irrespective of the political and social priorities of those who manage the economy. Any policy that has no corresponding increases in productivity may be short-lived and counterproductive. Our debt service obligations will be tied up with the projected government revenue internally. In other words, the internal economic activities will be able to produce enough revenue to the government in local currency equivalent to any debt service obligation. Our debt servicing problems will become easily manageable when productivity increases and growth resumes.

(iii) Embargo on further external borrowing

In view of Nigeria's external indebtedness vis-à-vis its declining foreign exchange earnings from its major resource, oil, the 1985 budget has emphasized government's decision not to borrow externally for new projects in the 1985 fiscal year. The only exceptions are projects considered absolutely essential in the public interest, such as agricultural and agro-allied projects, ongoing water projects in some States and for externally financed Federal and State projects spilling over from the 1984 fiscal year.

The decision not to borrow externally for new projects in 1985 is one of the reasons for the lack of sufficient stimulus given to the industrial sector.

Our present debt servicing problems were caused by both external and internal factors. The external was the uncontrollable world oil glut. The internal factors were due mainly to poor policies, inadequate management of available resources, dearth of technical and managerial skills, and lack of enough local institutions and personnel with analytical and forecasting capacity. It is clear that our past borrowing was far in excess of what was feasible and sustainable, and that our investment programmes were in many cases poorly articulated, too large and varied to be managed, and too ambitious. To worsen the matter there was an exaggerated and unjustified sense of optimism in the permanency of oil wealth, almost to the total neglect of agriculture and other non-oil sectors.

Taking the world at large, our present situation is not a unique phenomenon, calling for a "do or die" policy. It is, therefore, a mistake to decide that, at our present level, external borrowing, *per se*, even for new projects, is a bad thing. Any external borrowing embarked upon now would be to provide some therapy for the oil shock, and it would be applied to financing structural changes and activities which are relatively rapid disbursing. In the short run the focus would be mainly for effective utilization of existing capacity as well as its maintenance and rehabilitation. The financing of new investments would be restricted to activities that are relatively rapid disbursing or for allevation of hardship. There is nothing wrong with debt *per se*. The whole world exists on credit. Nations, corporations, or even individuals, thrive on debt. Credibility is maintained only by efficient debt management and not by imposing an embargo on further borrowing.

At our stage of development we need and will continue to need a substantial amount of external capital.[18] In order to do better, external support is almost indispensable, provided the support is properly utilized. Inward looking financing alone is not in our overall best interest.

F. A new decree on tax

A new decree to be known as the Finance (Miscellaneous Taxation Provision) Decree will be promulgated in 1985. The Decree will introduce amendments to the Income Tax Management Act 1961 and the Companies Income Tax 1979.

Some of the areas to be affected by the amendment include:

(i) The extension of deduction of tax at source or withholding tax to other items of income, such as contracts and fees accruing to individuals and companies, and increasing the existing rate of tax deduction at source from 12.5% to 15%. Deduction of tax at source was, hitherto, on rents, dividends, interest and royalties. The effect of the new policy on the withholding tax will be, hopefully, to narrow the areas of fraudulent declaration of income for tax purposes and to generate more revenue for the government. The tax deducted at source will remain a final tax only for non-resident taxpayers. This policy is a welcome development in view of the fact that it extends the tax burden to those who, otherwise, would pay insufficient or nil tax.

(ii) Some improvement in the earned income relief will be introduced. With the possible increase in the "free pay allowances" which are set against taxable incomes, assessable incomes would be diminished and tax liability accordingly reduced for many income taxpayers. The "free pay allowances" based on taxpayers' ability to pay cover personal reliefs, allowances for children, wife, and dependents as well as life assurance relief. In respect of personal income tax relief throughout the country, it has been revealed that for earned incomes up to ₦ 6,000 per annum, the relief will be ₦ 1,200 while for earned incomes in excess of ₦ 6,000 per annum, the relief will be 12.5% of the earned income.[19] The effect of this policy is to make the tax system more equitable, particularly in respect of those on PAYE who have traditionally borne the bulk of the tax burden in Nigeria. This is to be encouraged in this

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[18] Nigeria is yet to attain the $ 500 million annual loan earmarked for her by the World Bank in 1977 under its expanded programme. Since 1975, she has only fully drawn $ 744.1 million out of a total commitment of $ 2,454 million. (See *Business Concord* Editorial, 15 February 1985.)

[19] See Dapo Ajibola *Business Times* (Lagos: Nigeria), 14 January 1985 (quoting the Director of the Board of Inland Revenue, Mr. Ajibola Olounleke). It is to be observed, however, that for earned incomes in excess of ₦ 6,000 per annum, unless the Decree provides for a relief of the higher of ₦ 1,200 or 12.5% of the earned income, the effect, in some cases, will be absurd. This is because the 12.5% relief on incomes in excess of ₦ 6,000 but less than ₦ 9,600 will attract less than ₦ 1,200 which is a relief for incomes equal to or less than ₦ 6,000.

period of reduced real income of the working class.

(iii) The capital allowances rates (depreciation rates) have been reviewed and the period of claim (i.e. depreciation period) were accelerated by the new straight-line method of spreading annual allowances equally over the specified period of write-off. The practice of allowing a fixed rate on the residual value of the assets from year to year (i.e. declining balance depreciation) is to be discontinued. Since capital allowances are made against tax assessment, the acceleration of the period of claim under the new policy may result in a reasonable reduction in the assessable incomes in the early years of the use of the asset. The effect of this may be to improve the liquidity of the claimant companies in those years. This is advantageous to the companies in view of the time value of money.

By virtue of the new measure, the period of claim will be specific and it will be determined by a certain percentage of the capital. For example, if the capital allowance is to be claimed at 25% per year, the specific period for total claim would be 4 years.[20]

Under the new policy, too, the annual claim for capital allowances is to be restricted to a maximum of 75% of profits of the year in the case of manufacturing companies and 66⅔% in the case of other companies, However, agro-allied companies, as defined by the proposed Decree, are not subject to the restriction. The purpose of the restriction is to make it difficult for companies to declare capital allowances in excess of their profits. In this period of low government revenue, government cannot afford to grant 100% on capital allowances.

(iv) Loss relief will be available for set-off against future profits, but the period for carry-forward of any unabsorbed loss is once more restricted to 4 years. This measure was in operation in the 1976-77 fiscal year. The restriction of the period of carry-forward of losses is to discourage the practice of some companies that manipulate their accounts in such a way that they perpetually have losses to carry forward, thereby fraudulently reducing their taxable income and tax payable. This measure intends to plug another source of revenue drain for the government. The limitation of the period of carry-forward of losses will spur on companies to endeavour to make profits from the source of activity in which the unabsorbed loss was incurred so that the unabsorbed loss does not lapse. So, it has the advantage of making companies with unabsorbed losses more active and aggressive. However, the restriction of the period of carry-forward to 4 years may mean lower profits and lower taxes in those years – particularly where the unabsorbed losses are substantial.

(v) The turnover tax of 2½% imposed on the building and construction industry with effect from the 1977-78 fiscal year is now abrogated. The 2½% turnover tax was introduced to circumvent the practice of some contractors who habitually declared losses in order to evade tax, in spite of huge construction contract payments during the heydays of Nigeria. The turnover tax was paid on total turnover, including sums subcontracted, whether or not profit was made or declared. However, where profit was declared, the tax payable was either the 2½% turnover tax or the normal company income tax, whichever was higher.

With the abolition of the 2½% turnover tax, and with the extension of deduction at source or withholding tax to contracts, fees and other similar incomes, contract fees will now attract 15% withholding tax. It is expected that withholding tax will also apply to legal fees, retainerships and fees for services rendered.

The recipients of fees and income subject to deduction at source will still be assessed for income tax on their global income, and credit will normally be given for taxes already withheld at source.

(vi) The list of transactions for which tax clearance certificates will be demanded will be reviewed and legalised. The chances are that the list may be enlarged so that more people will be compelled to pay appropriate tax. In addition, certificates of "total pay and tax deducted" should continue to be issued promptly by employers to their employees or whenever an employee is leaving service. Such certificates will continue to be accepted by the banks for home remittances and basic travel allowances. For other transactions which are to be listed in the proposed Decree, the policy is that the normal tax clearance certificate from the relevant tax authority should be obtained.

(vii) The new tax policy will now require organisations or establishments approved for the operation of the Pay-As-You-Earn (PAYE) system to deduct at source, at a rate to be specified, some withholding tax from any incomes which may be due to a recipient or beneficiary, and to account to the government for tax so withheld, subject to penalties for failure to deduct or to pay over to the government what has been withheld. This is in a bid to bring every possible income within the income tax net and to generate more revenue for the government. However, in order not to have a disincentive effect, it is expected that the rate for such deduction will be fair to the taxpayer.

IV. CONCLUSION

In this analysis an attempt has been made to discuss some of the tax issues and tax implications of the 1985 policy objectives of Nigeria's Federal Government as contained in its 1985 Budget (and as expounded by the Finance Minister) within its overall policy framework for reviving Nigeria's battered economy. Some issues discussed bear directly on taxation while others bear only a cursory reference to taxation. Although it cannot be claimed that every tax issue or policy with tax implications has been discussed or analysed, some of the major tax issues were highlighted and their possible implications and effects considered in the light of our present realities and our past experiences. The issues raised and discussed are matters for more critical analysis within the context of Nigeria and the world in general.

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[20] Ibid.

BOTSWANA:

Capital Transfer Tax Bill, 1985

This summary was written by **Patricia Dunn, J.D.**, managing editor of *Bulletin for international fiscal documentation.*

Botswana has recently[1] drafted a Capital Transfer Tax Bill[2] designed to introduce a capital transfer tax on property disposed of by way of gift or inheritance. The new tax, presented to the Parliament on 18 April 1985,[3] will apply only to a transfer where there is an element of gift involved and will not apply to a disposal of property for money or money's worth.[4] At the same time, the Bill provides for repeal of and replaces the Death Duties Act.[5]

Capital transfer tax is to be charged on the aggregate taxable value of all chargeable disposals. A "chargeable disposal" is defined in the Bill as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right or any property devolving on any person by way of inheritance.

Liability for the tax falls on the beneficiary who, for purposes of the Act, is any beneficiary of a chargeable disposal and includes a trustee to whom such property has been disposed for the benefit of any beneficiary. Should the taxable property devolve on two or more persons in undivided shares, the aggregate value of said property shall be deemed to have accrued to each of them equally. Interestingly, a married woman will be liable for the capital transfer tax in her own name in respect of the aggregate value of a chargeable property accruing to her in any tax year. This is in contrast to the Income Tax Regulations wherein the income of a married woman not legally separated is deemed to accrue to her husband.[6]

Certain transfers are exempt from capital transfer tax, among them:

- transfers by way of inheritance to a spouse on the death of the other spouse;
- transfers to or for the benefit of one spouse during the lifetime of the spouses;
- transfers on marriage or in consideration of the performance of any customary rites where the value of such property does not exceed 2,000 P;
- household goods, chattels and personal belongings of a deceased person where the total value does not exceed 5,000 P; and
- livestock or produce which has been accounted for income tax purposes.

Property situated outside Botswana where the beneficiary entitled to it is domiciled outside Botswana, as well as property disposed of by the donor for the maintenance, education or training of his minor children,[7] is likewise exempt. Each person is entitled to receive casual gifts to a total aggregate value of not more than 2,000 P per tax year without becoming liable to capital transfer tax.

Certain deductions are provided for in the Act. The first 30,000 P,[8] in the case of the estate of a deceased person, is deductible or, where there is more than one beneficiary, the permitted deduction will be a part of 30,000 P in proportion to each beneficiary's share of the estate. Also, any expenditure wholly, exclusively and necessarily incurred by the donee in effecting the disposal of the property or obtaining possession is deductible.

After allowing for exemptions and deductions, tax will be chargeable on the aggregate taxable value as set out in the First Schedule (attached to the proposed Bill) as follows:

		Aggregate taxable value (in P)	*Rate of tax*
1.	Person (other than company)	First 30,000	3%
		Next 50,000	4%
		Next 100,000	5%
		Next 200,000	6%
		Balance	7%
2.	Resident company		35%
3.	Non-resident company		35%

As can be readily noted from the First Schedule, in addition to individuals, both resident and non-resident companies will also be subject to capital transfer tax.

Valuation of property for the purposes of the tax is set out in Clause 8(1) of the Act, which covers such situations as rights of ownership subject to a fiduciary, fixed or lifetime annuities, rights of enjoyment, etc. The Act provides that, in determining the value of any property, the Commissioner of Taxes may consult a qualified valuer or such other person as he considers necessary.

Finally, the Act provides for repeal of the Death Duty in respect of the estate of a person who died on or after 1 January 1979. Toward this end, transitional provi-

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[1] Bill No. 13 of 1985, published 29 March 1985 in the Botswana Government Gazette.

[2] Official title: An Act to provide for the levying of capital transfer tax on gratuitous disposal of certain properties and on inherited properties and other matters connected therewith.

[3] TNS-67 (1985).

[4] Transfers of real property for money or money's worth are generally subject to tax at the rate of 4% where the transferee is a Botswana citizen and up to 30% where the transferee is a non-citizen (Income Tax Act, 1973, as amended). The proposed Capital Transfer Tax Act will provide that where property has been disposed of for consideration which, in the opinion of the Commissioner of Taxes, is inadequate, such property will be liable to capital transfer tax (Capital Transfer Tax Act, hereinafter CTT, 1985, Clause 5(1)) although, in determining the taxable value of such property, the value will be reduced by an amount equal to the value of the consideration given for the property (CTT, 1985, Clause 5(2)).

[5] Death Duty Proclamation, 1959.

[6] *African Tax Systems* (Botswana), International Bureau of Fiscal Documentation.

[7] For the purposes of this Act, a "child" includes a lawfully adopted child and a step-child (CTT, 1985, Clause 4(2)).

[8] The 30,000 P was apparently increased to 40,000 P during Parliamentary debate. *Tax News*, Botswana, Coopers & Lybrand, 14 May 1985.

sions are included which provide for an election by the personal representative or beneficiaries, as the case may be, of the estate of the deceased either to treat the property disposed of as taxable under the Capital Transfer Tax Act or under the Death Duty Act. Such an election must be made in writing to the Commissioner of Taxes within 6 months from the day on which the Act comes into force.

Botswana's proposed Capital Transfer Tax Act has some similarity to the United Kingdom Capital Transfer Act[9] especially as it relates to exemptions. Some tax analysts are of the opinion that the U.K. Act, because of its extensive exemptions and other special reliefs, in fact brings in little revenue. It can only be hoped that the Botswana Act will not be subject to the same, or similar, weaknesses.

A notable difference between the U.K. Act and the Botswana Act is in the persons primarily liable for the tax. Whereas in Botswana, the donee, i.e. the beneficiary, is liable, in the U.K. primary liability falls on the transferor. Only where the tax is overdue does secondary liability fall to the transferee. By the same token, capital transfer tax in the U.K. is levied by reference to the effect on the transferor's estate; the value of the gift or inheritance to the transferee not being relevant. This is in direct contrast to the same tax in Botswana which appears to determine the aggregate value of the property in the hands of the beneficiary, especially in cases where such property includes a fixed or life annuity or a right to use and enjoyment.

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[9] United Kingdom Capital Transfer Tax Act, 1984. For an analysis of the U.K. Act, see 7-8 *European Taxation* (1984) at 266. It should be recalled that Botswana was a former protectorate of the U.K. and did not attain complete independence until 1966. As such it naturally relied on the U.K. legal system in formulating its own legislation.

Conference Diary

SEPTEMBER 1985

39th Annual Congress of I.F.A.: I. The assessment and collection of tax from non-residents. II. International double taxation of inheritances and gifts. London (United Kingdom), 8-13 September (English, French, German, Spanish).

Interphil: Interphil II (International Standing Conference on Philanthropy): Increasing government reliance on voluntary action – crisis or challenge? (including: comparative tax incentives for companies). Workshops on tax concessions and incentives to greater giving (a) by nation and (b) by international agreements. Venice (Italy), 26-28 September (English).

OCTOBER 1985

Asian-Pacific Tax & Investment Research Centre: Third Asian-Pacific Tax Conference. Kuala Lumpur (Malaysia), 7-8 October 1985 (English).

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: International tax law and tax planning (Seminar). St. Gallen (Switzerland) 21-24 October (German).

SEPTEMBER 1986

40th Annual Congress of I.F.A.: I. Transfer of assets into and out of taxing jurisdiction. II. Currency fluctuations and international double taxation. New York (U.S.A.), 7-12 September (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian-Pacific Tax & Investment Research Centre, 2 Nassim Road, Singapore 1025, Republic of Singapore.

European Study Conference Limited, Kirby House, 31 High Street East, Uppingham, Rutland LE 15 9PY, United Kingdom.

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

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

Interphil, Cedar House, Yalding, Kent, ME 18 6JD, United Kindom.

Oracle Business Information, 99c Thetford Road, New Malden, Surrey KT3 5DS, United Kingdom.

In next issues:

Taxation in the People's Republic of China (Tax Laws – Tax Incentives – Tax Treaties) A brief Introduction – by *Eugen Jehle*

Canada: Some Current Issues with Treaty Tax-sparing Provisions – by *Nathan Boidman*

The Role of Tax Treaties as an Instrument of Economic Cooperation between "Capitalist" and "Socialist" Countries – by *Helmut Debatin*

Collaboration Agreements – Some Issues – by *M.B. Rao*

U.K. Taxation and Currency Fluctuations – by *Jill C. Pagan*

United Kingdom: A New Approach by the Courts after Furniss – by *John Avery Jones*

The Policy and the Practice of the United Kingdom in the Tax Treatment of Transfer Pricing – by *M.H. Collins*

EUROPEAN COMMUNITIES

Financing the Community

On 19 April 1985 the Commission of the European Communities published 2 important documents, i.e.:[1]

- *Report from the Commission on the implementation of Council Regulations (EEC, Euratom, ECSC) Nos. 2891/77 and 2892/77 of 19 December 1977 implementing the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources;*
- *Proposal for a Council Regulation (EEC, Euratom, ECSC) extending the term of validity of Regulation (EEC, Euratom, ECSC) No. 2892/77 implementing, in respect of own resources accruing from value added tax, the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources.*

The role of finance for the Communities is of crucial importance since large sums are required for their proper functioning. Because of the significance of these documents they are reproduced in their entirety in this issue of the Bulletin.[2]

Since then the EC Council issued its decision of 7 May 1985.[3] *In summary this decision provides that, as is currently the case, the Communities will be financed by the revenue from agricultural levies (including duties imposed on sugar), customs duties charges introduced within the framework of the EEC Treaty or the Euratom Treaty and a uniform rate of VAT to be assessed on a uniform assessment base which was or should be adopted by the EC Member States. The maximum rate of VAT which may be adopted for purposes of financing the Communities will be 1.4% as of 1 January 1986 and this rate may be increased to 1.6% on 1 January 1988 by unanimous decision of the Council and after agreement has been reached in accordance with national procedures. However, special measures have been taken to reduce the contribution of the United Kingdom and to increase the contribution of the other States accordingly. The increase of the contribution by the Federal Republic of Germany has been limited.*

Contents

N.B.: – The text of this report has been closed on 15 February 1985.
– All references for documents cited are given in Annex I.

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1. COM (85) 170 final.
2. See also "The Future Financing of the Community – The EEC", Green Paper, 37 *Bulletin* 11 (1983) at 497.
3. Official Journal of the European Communities (hereinafter "OJ") No. L 128 of 14 May 1985 at 15 (not reproduced herein).

INTRODUCTION

The basis of the Community own resources system is the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources. The implementing rules are contained in the following regulations:

- Council Regulation (EEC, Euratom, ECSC) No. 2891/77 of 19 December 1977 implementing the Decision of 21 April 1970. In 1982, 1983 and 1984 the Commission proposed amendments to this regulation which are still being considered by the Council. The regulation is not limited in time;
- Council Regulation (EEC, Euratom, ECSC) No. 2892/77 of 19 December 1977 implementing in respect of own resources accruing from value added tax the Decision of 21 April 1970. This regulation was originally due to expire at the end of 1982 and in July of that year the Commission proposed amendments to it. Following its extension to the end of 1985 by Council Regulation (ECSC, EEC, Euratom) No. 3550/82 of 28 December 1982, amendments based on the Commission's proposals were made by Regulation (EEC, Euratom, ECSC) No. 3625/83 of 19 December 1983.

When it was consulted about the proposed amendments to these regulations and also in its resolution on the discharge for 1981, Parliament drew the Commission's attention to certain points connected with the implementation of the Decision of 21 April 1970; it asked the Commission to prepare a report on the implementation of Regulations Nos. 2891/77 and 2892/77 by the end of 1984.

This report has therefore been designed to serve two purposes:

- to provide the evaluation of the operation of the own resources system requested by Parliament;
- to conform to the obligation referred to in the article 14 of Regulation No. 2892/77 as amended and to propose, in the light of the conclusions of this report, a three-year extension, to 31 December 1988, of Regulation No. 2892/77.

PART ONE

REPORT ON THE IMPLEMENTATION OF COUNCIL REGULATIONS (EEC, EURATOM, ECSC) NOS. 2891/77 AND 2892/77 OF 19 DECEMBER 1977

implementing the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources

1. Background and purpose

This report has been prepared in response to various requests by Parliament, notably when it was consulted about the Commission's proposals for amendments to Regulations Nos. 2891/77 and 2892/77, and ahead of the expiry of Regulation No. 2892/77 on 31 December 1985. It covers the whole of the own resources system, dealing in turn with the implementation of Regulations Nos. 2891/77 and 2892/77. It is an interim report in the sense that it has been prepared at a time when the rules governing the own resources system are undergoing a series of changes.

1. In a number of resolutions, listed in Annex I, Parliament asked the Commission to prepare by 31 December 1984 a report on the implementation of the rules on the Community system of own resources, with particular reference to a number of specific aspects: the way the VAT base is determined, problems of using statistics and national accounts and the treatment of own resources in national budgets.

2. Because work on the revision of the implementing regulations with which it deals has not progressed in accordance with the timetable foreseen in 1982, the date for which the report was requested falls awkwardly. The present situation, which is described in detail below, needs to be outlined here so that the background to the preparation of the report can be properly understood.

3. Council Regulation (EEC, Euratom, ECSC) No. 2891/77 of 17 December 1977 implementing the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources came into force from the 1978 financial year. Amendments were proposed in July 1982 and this proposal was itself amended three times subsequently.

The original proposal and the later amendments to it are still being considered by the Council.

4. On account of delays in implementing the Sixth VAT Directive, Council Regulation (EEC, Euratom, ECSC) No. 2892/77 of 19 December 1977 implementing in respect of own resources accruing from value added tax the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources was not implemented until 1979 (and then only by six Member States – Belgium, Denmark, France, Italy, the Netherlands and the United Kingdom – until 1979; all nine Member States applied it in 1980). It was originally to apply for a transitional period ending on 31 December 1982 and in July of that year the Commission proposed amendments, which were subsequently amended themselves in the light of Parliament's opinion. This led to the adoption of Council Regulation (ECSC, EEC, Euratom) No. 3550/82 of 28 December 1982 and Council Regulation (EEC, Euratom, ECSC) No. 3625/83 of 19 December 1983.

These regulations extended respectively the transitional period to 31 December 1985 and provided for the Commission to report on implementation of the regulations by 31 December 1984.

5. Greece has participated since accession in the Community system of own resources, paying over to the Community budget customs duties, agricultural levies and sugar and isoglucose storage and production levies. However, on 19 December 1983 the Council adopted its Fifteenth Directive on the harmonization of the laws of the Member States relating to turnover taxes – deferment of the introduction of the common system of value added tax in the Hellenic Republic, which authorized Greece not to introduce VAT until 1 January 1986. Until that date it will pay a financial contribution based on its share of Community GNP.

Spain and Portugal will contribute to the Community budget from the date they joint but they will not fully apply the Decision of 21 April 1970 immediately; they will implement it gradually during a transitional period.

6. The Decision of 21 April 1970, implemented by Regulations Nos. 2891/77 and 2892/77, is itself being amended. To give effect to the conclusions of the Fontainebleau European Council in June 1984, the following month the Commission sent the Council an amendment to the proposal for a decision on Community own resources which it had sent to the Council in May 1983. The adoption of this decision will mark an important step in the development of Community own resources, since it will change not only their amount but also their role.[4] This means that there may well also be changes to the entire context in which the implementing regulations are applied.

7. It is also worth noting that since June 1978 a number of amendments have been proposed to the Financial Regulation of 21 December 1977 applicable to the general budget of the European Communities; these are now being considered by the Council after having received the opinion of the European Parliament. In a number of instances, consistent or even identical solutions must be found to problems arising under both the own resources rules and the Financial Regulation.

8. The report requested by Parliament should logically conclude with proposals on the choice of a single, definitive method for determining VAT own resources. But the achievement of this objective is subject to three constraints.

The first is that Regulation No. 2891/77 is still in the process of being amended and so the conclusions of the report on its implementation presented in 1982 have not yet been transformed into regulations. While

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[4] *Editor's note:* Decision of 7 May 1985. See note 3 and accompanying text.

certain aspects of that report can now be dealt with in more detail, the Commission is unable to report new developments on all the points raised by Parliament, since a number of these relate to provisions on which no decision has yet been taken.

Secondly, although Regulation No. 2892/77 was amended in time to be used for the calculation of 1983 VAT bases, the Commission has as yet no experience of the new provisions since the statement setting out the calculation of the 1983 VAT base was not sent by the Member States until July 1984, as stipulated in Article 10. Furthermore, the fact that eight Member States[5] have now opted for the "revenue method" has created a situation quite different from that originally envisaged and one which is made even more uncertain by the delays with the VAT harmonization directives.

Finally, it would be somewhat artificial, and in any case impracticable, to separate too rigorously the problems of implementing Regulation No. 2891/77 from those involved in the implementation and amendment of Regulation No. 2892/77. The system for implementing the Decision of 21 April 1970, or any decision which replaces it, must continue to form part of a complete and coherent whole.

9. The Commission has therefore made two choices in deciding on the form this report should take:

- it intends to cover *all problems raised by the implementation of the own resources system,* that is those raised by the various institutions in respect of both Regulation No. 2891/77 and Regulation No. 2892/77;
- because of the lack of a decision on amendments to Regulation No. 2891/77 and the lack of experience of implementing the new version of Regulation No 2892/77, it is an *interim report.* A further reason for this is the decision to send the Council a proposal for extending Regulation No. 2892/77 as last amended by Regulation No. 3625/83.

2. Implementation of Regulation No. 2891/77

2.1 Position regarding proposals for amendment

The amendment of Regulation No. 2891/77, which began with the presentation of the Commission's first proposals in July 1982, has not yet been completed, and the Commission's various proposals are still being examined by the Council.

10. Regulation (EEC, Euratom, ECSC) No. 2891/77 implementing the Decision of 21 April 1970 on the replacement of financial contributions from the Member States by the Communities' own resources, adopted by the Council on 19 December 1977, replaced Council Regulation (EEC, Euratom, ECSC) No. 2/71 of 2 January 1971 which had governed the implementation of the Decision of 21 April 1970 from 1971 to 1977.

11. Article 22 of Regulation No. 2891/77 stipulated that the Commission should submit, by 30 September 1979, a report on implementation together with, where appropriate, any proposals for amendments.

In fact, it was in July 1982 that the Commission sent the Council the first report on the implementation of Regulation No. 2891/77. This delay in relation to the date originally planned was mainly due to the need to take into account the initial experiences of the operation of VAT own resources. Since this did not take place in all the Member States until 1980, the Commission did not receive the first statements of the VAT base for all the Member States until July 1981.

12. The objectives of the proposal for an amendment to Regulation No. 2891/77 were described in the accompanying report and explanatory memorandum and will not be dealt with in detail here. However, it should be recalled that, in addition to a number of adjustments which could be described as technical, this proposal sought changes on the following points:

- reports to be produced by the Member States on the entry of own resources in the accounts and the problems encountered with inspection and disputes;
- the possibility for the Commission's accounts with the national treasuries to bear interest;
- calculation of interest on late payments;
- rules for making available adjusted amounts after the adoption of an amending or supplementary budget or if no budget has been adopted;
- incidence on the budget of corrections to VAT statements;
- treatment of balances;
- attribution to the Commission of autonomous powers of inspection.

After consulting Parliament in December 1982, the Commission submitted in May 1983 the first amendment to its proposal concerning:

- the financial institutions with which the Commission has accounts;
- the rules for making resources available if no budget had been adopted;
- the calculation of interest on late payments;
- the presentation of a report on implementation by the end of the third year in which the amended Regulation has been applied.

13. In October 1983 the Commission sent the Council a second amendment to its proposal amending Regulation No. 2891/77. The aim of this amendment, announced in the implementation report of July 1982 and submitted in response to the conclusions of a report on the establishment of own resources (customs duties and agricultural levies) in the Member States was to:

- define more precisely the concept of establishment;
- specify in what circumstances and subject to what conditions the making available of established entitlements may be deferred;
- specify in what circumstances and subject to what conditions a member State may be definitively released from its obligations to make entitlements available.

After being consulted on this second amendment in May 1984 and following a conciliation meeting with the Commission under Rule 36(2) of its rules of procedure, Parliament hoped that the Commission would make clearer that own resources belong to the Communities from the moment that the event entitling them to be levied occurs, achieve progress towards harmonization of corresponding national provisions and define more precisely the exceptions to the obligation to make entitlements available. In July 1984 the Commission sent the Council the third amendment to its proposal incorporating all the amendments adopted by Parliament.

14. In spring 1985 all these proposals amending Regulation No. 2891/77 are still being examined by the Council; discussion centres on the most sensitive aspects of the Commission's proposals, in particular those connected with the possibility for the Commission's accounts to bear interest and the attribution to the Commission of autonomous powers of inspection.

The Commission would point out in this respect that it shares Parliament's desire, expressed in May 1984 when consulted on the second amendment to the proposal amending Regulation No. 2891/77, that revision of this regulation should be speeded up and brought to an end.

2.2 Establishment and making available

The current rules regarding the establishment and making available of the Communities' own resources need to be made clearer; this was the purpose of the latest proposals for amending Regulation No. 2891/77.

15. The rules to be followed by the Member States for the establishment and making available of own resources are laid down in Article 1 of Regulation No. 2891/77, which obliges them to establish customs duties and agricultural levies in accordance with their own provisions laid down by law, regulation or administrative action. Article 2 states that, for the purpose of applying this Regulation, an entitlement shall be deemed to be established as soon as the corresponding claim has been duly determined by the appropriate department or agency of the Member States. These two articles thus refer to the national provisions of each Member State to determine whether and when establishment should take place. Community customs legislation has started harmonization of the concepts and procedures directly linked with the establishment of entitlements without, however, resulting directly in a more precise definition of this concept.

Articles 9 and 10 of Regulation No. 2891/77 state that the customs duties and agricultural levies should be credited by each Member State to the account opened for this purpose in the name of the Commission with its Treasury or with the body it has appointed by the 20th day of the second month following the month during which the enti-

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[5] The Hellenic Republic does not yet pa VAT own resources.

tlement was established. Under Article 17, Member States are free from the obligation to place established entitlements at the disposal of the Commission solely if, for reasons of *force majeure,* the amounts have not been collected.

16. The Member States therefore have an obligation to establish traditional own resources, and the obligation to make the own resources available relates to the established entitlements and not to the revenue collected. However, there have been many difficulties, i.e. in meeting these obligations when imports have not taken place under normal conditions.

17. The first difficulty is that Regulation No. 2891/77 gives a definition of establishment which refers to national provisions for determining the corresponding claim. It does not therefore necessarily lead to uniform or even sufficiently harmonized application to guarantee the equivalent result in financial terms in the various Member States.

18. A second difficulty involves application of the concept of *force majeure,* the only exception to the obligation to make available an established entitlement. The Commission, in line with Court rulings interpreting the concept of *force majeure* in other contexts, informed the Member States at an ACOR[6] meeting that it considered *force majeure* to depend on outside factors which were unforeseeable and irresistible, and ruled out cases in which recovery was impossible for reasons such as the disappearance or bankruptcy of the taxable person. However, it appears that this definition is not applied uniformly in all the Member States.

19. In addition, current Community law contains an important exception to the principle that all own resources must be established and made available to the Commission irrespective of whether they are collected. This is in Article 9 of Council Regulation (EEC) No. 1697/79 of 24 July 1979 on the post-clearance recovery of import duties or export duties which have not been required of the person liable for payment on goods entered for a customs procedure involving the obligation to pay such duties.

Article 9 states that, until the implementation of Community provisions specifying the conditions under which Member States shall establish own resources, they are not obliged to, where, pursuant to this Regulation, they have taken no action for the post-clearance recovery of such duties.

20. In October 1983 the Commission presented the second amendment to its proposal amending Regulation No. 2891/77 to provide a more harmonized definition of establishment and the rules for making own resources available. The object was to define more precisely the concept of establishment by referring to the concept of entry in the accounts and to specify the circumstances and conditions under which Member States may defer the making available of established entitlements or may be definitively released from this obligation.

21. The introduction of the concept of entry in accounts to supplement the definition of establishment for the purposes of own resources presents a number of advantages. It is a concept which is harmonized at Community level; customs law has transposed it into practice through a number of regulations and it is thus applied in everyday customs operations. It obviates the need to use the concept of a claim by the public authorities on a taxable person, as harmonization of this would demand a thorough reform of the legal or even constitutional systems of the Member States.

In practice, this provision would not alter the current situation in the cases which do not create difficulties, which are the vast majority of cases; as soon as the chargeable event takes place, the entitlements will be established and entered in the accounts in accordance with Community rules and then made available as at present. On the other hand, in cases where entry in the accounts cannot take place normally, the establishment will take place as soon as an administrative authority has calculated the amount of the entitlements which it considers should be claimed from the taxable person, the advantage then being that all the Member States have to determine a figure for entitlements evaded (perhaps only a provisional figure) if only for the purposes of starting court proceedings.

22. As the concept of *force majeure* has not been applied satisfactorily, the Commission has proposed that it be replaced by provisions to implement and effectively control cases in which there could be exceptions to the obligation to make own resources available.

These proposals would provide extremely strict rules to govern cases in which public authorities unable to recover entitlements owing to unforeseeable circumstances beyond their control could be released from the obligation to make own resources available. They would also provide for the conditions for making own resources available to the Commission to be adjusted to the actual possibilities of the Member States in certain cases determined in advance and, in return, ensure that the Commission is given the necessary information on the type of case and the procedure applied.

2.3 Inspection and frauds

The Commission's powers on inspection and correction of irregularities affecting traditional own resources remain inadequate and must be increased as the Commission suggests in its proposals for amendments to Regulation No. 2891/77 and the Regulation on irregularities.

23. The procedure for inspecting own resources is set out in Article 18 of Regulation No. 2891/77 which states that Member States shall carry out the verifications and inquiries concerning the establishment and the making available of own resources and that they shall carry out any additional inspection measures the Commission may ask for in a reasoned request. They must also associate the Commission, at its request, with the inspection measures which they carry out.

Regulation (EEC, Euratom, ECSC) No. 165/74 of the Council of 21 January 1974 determining the powers and obligations of officials appointed by the Commission also applies to these inspections. Article 4 of this Regulation states that these inspections should relate to the establishment, based on information available to the national departments, of own resources, accounting therefor and making available thereof, the conformity of these operations with Community rules and the existence of supporting documents and their conformity with these operations.

24. Although own resources have been allocated to the Communities, the Commission still exercises no more than imperfect control. Firstly, the Commission can only inspect the activities of the administrations and bodies concerned, without being able to control taxpayers directly. The only exception to this rule is the inspection of sugar levies for which the Commission is associated in the inspection of the accounts and stocks of sugar producers in some Member States. Similarly, the Commission cannot carry out independent inspections and must provide the Member States with a reasoned request for additional inspections. Although these provisions have not so far raised any particular difficulties and Member States have always agreed to the Commission's requests, a question of principle is involved which still has not been settled satisfactorily, since the Council has not yet taken a decision on the Commission proposal that it should be allowed to conduct its own inspections.

25. It is no easy matter to present and, above all, justify a judgment on the findings of the inspections and on their effectiveness. A quantitative evaluation is especially difficult in the case of traditional resources.

The inspections are of a one-off nature and cover the operations conducted over a given period by a specific customs office. Some entries in the books may be corrected on this occasion, but the main effect produced by the comments made during the inspection visits is to improve application of Community rules as regards any problems detected; this of course has implications for all operations of the same type. It is difficult to quantify the effects, and a simple financial balance sheet of the direct results cannot really be representative.

26. For all types of resources, the inspections are the Commission's main opportunity for checking that the Community system of own resources is operating properly as regards application not only of the financial regulations but also of customs and tax law. However, these inspections cannot systematically detect cases of fraud and irregularities on the part of the taxable persons and it must be admitted that the Commission's information on these cases is far from being as complete as it should be.

27. An appreciable improvement in the information sent to the Commission has been realised due to Council Directive 76/308/EEC of 15 March 1976 on mutual assistance

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[6] *Editor's note:* ACOR stands for Advisory Committee on Own Resources, see 2.5 below.

for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of the agricultural levies and customs duties and value added tax and Council Regulation (EEC) No. 1468/81 of 14 March 1981 on mutual assistance between the administrative authorities of the Member States and cooperation between the latter and the Commission to ensure the correct application of the law on customs or agricultural matters. However, this information is still far from exhaustive, and covers only partly the financial effects of the files evoked.

Under Article 17 of Regulation No. 2891/77, Member States must also present a six-monthly report on the most important problems arising out of application of this Regulation and in particular matters in dispute. These reports provide a good deal of information on the difficulties encountered by the Member States in implementing the own resources system.

Although Member States adopted a new layout in 1983, this information is still general and not suited to a detailed analysis of individual cases of frauds and irregularities. The Commission's initial information on these cases is often obtained via far less formal channels such as national newspapers or direct contact with national administrations.

28. There is still no channel of regular, systematic and compulsory information on cases of fraud and irregularities. In March 1979 the Commission tried to fill the gap by transmitting to the Council a proposal for a Council Regulation on the measures to be taken in the event of irregularities affecting the own resources referred to in the Decision of 21 April 1970 and the organization of an information system for the Commission in this field. Under this proposal, which covered all own resources, the Commission would have been informed every three months of irregularities which have been the subject of an initial official record of an administrative or legal nature and the action taken as a result. However, the Council has still not taken a decision and in February 1984 the Commission asked it to resume its examination of the proposal.

It should also be noted that the proposals for amending Regulation No. 2891/77 as regards the establishment and making available of own resources include a whole series of obligations for informing the Commission and the Member States on cases involving this type of problem.

2.4 Treatment of own resources in Member States' budgets and national accounts

The treatment of the Communities' own resources in national budgets and national accounts is not always in keeping with the nature of these resources. Despite the difficulties linked with the diversity of the national budget systems, this situation could be improved.

29. The problem raised by Parliament in point 4 of its resolution closing the procedure for consultation on the proposals from the Commission concerning amendment of Regulation No. 2891/77 actually covers two different problems: budget documents and national accounts are different in nature and scope.

Budget documents are the legislative expression of the authorization to collect revenue and effect expenditure and permit inspection of these operations; national accounts have no legislative value and aim only to provide statistical information on the performance of the national economy. Furthermore, budget documents have a wide diversity of form and content while the national accounts have a harmonized structure.

30. Despite this diversity, the budget documents of the Member States can be divided into three main categories:

- the year's finance law or laws containing estimates and authorizing all or part of State revenue and expenditure;
- the annexed statements which explain some of the provisions of the finance laws and thus have equivalent legal value;
- the annexes to the finance bill which, since they are for information purposes only, have no legal value.

31. The logic of the own resources system would require that they should not be entered in a budget to receive legislative authorization, since they have been allocated once and for all to the Community budget and control should not be the responsibility of the national parliaments but of the Budgetary Authority of the Communities. However, the legal, tax and budgetary rules of all the Member States provide that public revenue must receive legislative authorization in one form or another.

Since the collection of the Communities' own resources is still performed by the national authorities, the above principle has not yet been applied in full in all the Member States.

Annex II contains a description of the practices of each Member State on the treatment of own resources in *national budget documents*. This account clearly shows that up to now only Belgium, Germany, Luxembourg and the Netherlands have a method of presentation anywhere near in keeping with the nature of own resources. The presentation employed in Denmark and France is still ambiguous. The most that can be said of the other Member States is that their methods of presentation and information have no major practical implications either politically or legally.

32. The national accounts present a retrospective image of the national accounting system. They provide a framework in which are classified the various economic operators and the operations they conduct and give all the corresponding figures, derived from observation, summaries and statistical processing. The drafting of these national accounts thus requires strict definitions which, since 1970, have been set out for the Community in the European System of Integrated Economic Accounts.

The description of *national accounting practices* given in Annex II shows that, except for Germany and depending on how the Greek national accounting system develops, the Member States treat own resources in their national accounts in accordance with Community rules.

2.5 Advisory committee on own resources

For nearly fifteen years the ACOR has proved to be a particularly efficient forum for discussing problems related to the operation of the own resources system.

33. Articles 20 and 21 of Regulation No. 2891/77 set up an Advisory Committee on Own Resources (ACOR). The Committee is chaired by a representative of the Commission and consists of representatives of the Member States and of the Commission. Its role is to examine all questions related to application of Regulation No. 2891/77 and, in particular, the findings of inspections and the reports sent periodically to the Commission by the Member States on the questions of principle concerning the most important problems arising out of application of the Regulation.

34. In fact, the ACOR meets in three formations with different fields of activity:

- the ACOR "meeting under Article 21 of Regulation No. 2891/77", which is responsible for general problems of implementing this Regulation and for examining inspection reports on traditional resources (customs duties, agricultural and sugar levies);
- the "Estimates" subcommittee, which is responsible for examining the estimates of own resources drawn up by the Member States and the Commission as part of preparations of the preliminary draft budget and preliminary supplementary and amending budgets;
- the ACOR "meeting under Article 13 of Regulation No. 2892/77", which is responsible for problems in implementing Regulation No. 2892/77 which extended the Committee's field of activity to VAT own resources.

35. In November 1984 the ACOR "meeting under Article 21 of Regulation No. 2891/77" held its 49th meeting since it was set up in July 1971. Its activities have concentrated on examination and discussion of the reports on the inspection of traditional own resources in the Member States, thus providing a comparison of the situation in the various countries. However, its meetings have also resulted in a number of solutions to specific problems arising from implementation of Regulation No. 2891/77.

2.6 Conclusion

The amendments to Regulation No. 2891/77 need to be adopted as soon as possible.

36. For the Commission, the prime objective in connection with Regulation No. 2891/77 is to complete its amendment. The two series of proposals transmitted to the Council since July 1982 will enable considerable progress to be made on several issues, both questions of principle and operation. In conjunction with other rules, such as the Regulation on irregularities, Regulation No. 2891/77 could serve as an effective

means of implementing the Decision of 21 April 1970 and the new decision on the system of own resources for the Communities.

37. Until a decision has been taken on the Commission's proposals and until this first revision has been completed, any report on implementation of Regulation No. 2891/77 must inevitably be interim, since it can deal only with developments deriving from the original provisions of the Regulation.

However, the Commission considers that the undertaking given in the first amendment to its initial proposal at Parliament's express request must be respected: within three years of the entry into force of the amended Regulation No. 2891/77 the Commission will present Council with a report on its implementation which, where appropriate, will result in new proposals for amendment.

3. Implementation of Regulation No. 2892/77

3.1 Present state of the Regulation

The amended version of Regulation No. 2892/77 adopted at the end of 1983 was used for the first time to calculate VAT own resources bases for 1983, which were sent to the Commission in mid-1984. The amended version will remain in force until the end of 1985.

38. Article 14 of Council Regulation (EEC, Euratom, ECSC) No. 2892/77 of 19 December 1977 implementing in respect of own resources accruing from value added tax the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources provided for the Regulation to apply from 1 January 1978 for a transitional period ending on 31 December 1982. This article also stated that the Council, acting on a proposal from the Commission, should adopt, before 30 June 1982, the provisions relating to the definitive uniform system for levying VAT resources and the detailed rules for implementing this system. The length of the transitional period was initially set at five years.

39. In practice, however, since most Member States found difficulties in implementing the Sixth VAT Directive from 1 January 1978, actual implementation of Regulation No. 2892/77 was postponed to 1 January 1979 in the case of six Member States (Belgium, Denmark, France, Italy, the Netherlands and the United Kingdom) and to 1 January 1980 for the other three (Germany, Ireland and Luxembourg). Since Greece was authorized by the Fifteenth VAT Directive not to introduce VAT until 1 January 1986, until that date it will continue to pay a financial contribution based on its share of Community GNP.

The provisions of Regulation No. 2892/77, and in particular Article 10, were such that the Commission did not receive VAT statements from all the Member States until 30 June 1981. These related to 1980. This meant that the first full set was not available until two years later than originally planned.

40. In July 1982, in the light of this initial experience, the Commission nevertheless sent the Council a proposal to amend Regulation No. 2892/77 and extend it from the end of 1982 to the end of 1985 so as to restore the original five-year transitional period. The proposals for amendment concerned:

- the method of determining the correction to the VAT own resources base required in respect of transactions by taxable persons with an annual turnover of less than 10 000 ECU;
- the concept of estimated assessments;
- the method of calculating the weighted average rate and, in particular, questions connected with the definition of categories of consumption, arrangements for dealing with consumption on the farm and direct sales by flat-rate farmers, the order in which statistical sources are to be used, the treatment of changes in VAT rates during the year and the weighting to be given to the different rates;
- methods of calculating under-compensation for flat-rate farmers' inputs;
- the content of the annual statement of the VAT base;
- corrections to the VAT base;
- the procedure for taking decisions on authorizations and solutions relating to the calculation of the VAT base.

41. Parliament was consulted on this proposal. In December 1982 it gave a favourable opinion and also asked amendments dealing with:

- the treatment of corrections to the VAT base so as to afford the Commission greater opportunities for using its own initiative;
- a report on the implementation of the amended regulation;
- the procedure for taking decisions on authorizations and solutions.

In March 1983, acting in response to this opinion, the Commission sent the Council an amended proposal incorporating the first two of the points made by Parliament; the third was considered premature at this stage.

42. Since Regulation No. 2892/77 was to expire on 31 December 1982 and the Council had not at that stage acted on the Commission's proposed amendments, Regulation (EEC, Euratom, ECSC) No. 3550/82 was adopted on 28 December 1982 to extend Regulation No. 2892/77 until 31 December 1985; the Council was to reach a decision on the Commission's proposals concerning a definitive uniform system before 30 June 1985.

One year later, on 19 December 1983, the Council adopted Regulation No. 3625/83 amending Regulation No. 2892/77. In view of the final date for revision laid down by Regulation No. 3550/82 and Parliament's request for a report on implementation to accompany proposals for a single method of determining the basis of collection to be made by 31 December 1984, the revised version applies to VAT bases from 1983 for a transitional period expiring on 31 December 1985.

The Member States accordingly sent to the Commission by 30 June 1984 the statements of their VAT bases for 1983, the first prepared in accordance with the amended version of Regulation No. 2892/77.

3.2 Choice of method for determining the VAT base

From 1983 eight Member States use the revenue method (method B) instead of the returns method originally proposed by the Commission and endorsed by Parliament. This means that the transitional period for implementing Regulation No. 2892/77 has produced the opposite of what was intended by the Commission and Parliament.

43. The Commission originally proposed that the VAT base should be calculated in accordance with a method based on returns from taxable persons during a given year (the "base on base" or "returns" method).

However, although the Council, when adopting Regulation No. 2892/77, agreed that a single system could be used for collecting VAT own resources, the Member States were allowed to choose for a transitional period between the above method (method A) and the revenue method (method B), which determines the own resources base by applying the rate or rates in force during the year to the total revenue collected during that year.

The main difference between the two methods is that, in principle, method A is based directly on the returns made by taxable persons – subject to the treatment of estimated assessments – while method B involves calculations which are not exclusively of a fiscal nature.

44. Since 1979 or 1980 seven Member States – Belgium, Germany, France, Italy, Luxembourg, the Netherlands and the United Kingdom – have used the second method. Denmark and Ireland originally opted for method A but Denmark will use method B to calculate bases from 1983 onwards and Ireland remains the only Member State using method A to calculate its VAT base.

45. This means that some harmonization has taken place since all the member States except one are using the same method. This method, which does not reflect the original wishes of either the Commission or Parliament, raises problems, both as regards the calculation (these are described in section 3.5) and the principles relating to the very concept of own resources. There are a number of aspects of the method which must be considered.

46. It should first be borne in mind that Community own resources accruing from VAT were designed to provide funds to meet the Community's budget needs in a manner which would demonstrate a direct link between the taxpayer and the budget. The large number of rates applied in the Member States and the variety of national taxation policies ruled out any form of direct collection. Use of the returns made by taxable persons in method A did, however, retain this link while method B, which is based on the revenue received by the Member

State, tends to make the Member State itself the actual taxpayer. Like Parliament, the Commission has constantly deplored the insertion of an intermediary between the Community citizen and the Community budget.

It is nevertheless true that, even calculated by method B, VAT own resources are derived from the first tax to be harmonized at Community level. The recent discussions about raising the ceiling on these resources have clearly imprinted on public opinion in the Member States the role which VAT plays in financing the work of the Community.

47. The second point to make is that in view of the difficulties which the Member States have invoked in support of their claim that method A is unworkable, particularly the inadequacy of the returns for that purpose, the use of another method, albeit less direct, is perhaps the only way of ensuring the payment of VAT own resources without further considerable delay. It is pertinent to ask what was the point of a transitional period during which the Member States were able to choose between the two methods; since method B is fundamentally different from method A, it provided no preparation for the Member States to change to method A but instead required them to adopt a relatively complex mechanism which would not otherwise have been required.

48. Do the two methods produce the same result? Here a number of comments may be made.

The aim of method B is to reconstitute the base from the revenue collected by the Member State. This means that it involves a stage more than method A, where the base may be calculated directly by subtracting taxable amounts, corresponding to tax which has been deducted, from total taxable amounts. The aim of method B is thus the same as that of method A, but it pursues it in an indirect way. Moreover, because of the lack of precision in returns concerning zero-rated transactions in Member States using method A, large statistical corrections not unlike those used in method B have had to be made. The case of Denmark, which has just changed from method A to method B, is instructive. The 1983 VAT base (calculated by method B) was 6.9% larger than the 1982 base (calculated by method A). This appears more or less in line with the growth rates of previous years (1981-82: 10.7%; 1980-81: 5.6%; 1979-80: 6.7%).

49. Some guidance may also be gleaned from an exercise requested during the preparation of Regulation No. 3625/83 when the base used for the determination of VAT own resources was evaluated using data taken from the ESA. Details of these calculations are given in Annex III. It will be seen that the difference between the amounts derived from national accounts figures and the VAT bases calculated by the Member States does not appear to be related to the method of calculation used. The VAT base calculated by Denmark was appreciably lower than that derived from the national accounts, while that calculated by Ireland was slightly higher.

50. One of the factors determining the choice between the two methods is their respective costs and the differences in the administrative charges which they entail for both taxable persons and the departments responsible for controls. These points were stressed by the Member States during the discussions which culminated in the Council proposing the possibility of a choice during the transitional period.

It is very difficult to assess the differences, mainly because no comparison can be made within the same Member State and there is no precise information on the real cost to the Member States of preparing the statement. In any case, they would at best have information only on the costs involved with the method they use.

What is clear is that method A requires returns from taxable persons to contain details, particularly on the breakdown of purchases by rate, which were not always required when national VAT systems were set up, while method B uses figures which should already be available to the national administrations. However, experience has shown that the use of these figures for the purposes of Community own resources demands special processing or a certain amount of specific research.

3.3 VAT base: Purpose and control

The own resources base is calculated annually by the Member States and controlled by the Commission. The control and the meetings of the Advisory Committee for Own Resources provide an opportunity to settle a number of technical problems raised by the implementation of Regulation No. 2892/77. These inevitably involve corrections to the base, sometimes affecting bases dating back a number of years.

Since the base is derived from returns made by taxable persons or the revenue collected by the Member State, the Commission has at present no means for direct action concerning VAT frauds.

51. Whatever the method used to establish the base, VAT own resources are made available to the Commission in accordance with Article 10(3) of Regulation No. 2891/77. This is done on the first working day of each month by crediting the accounts opened for this purpose by the Member States with one twelfth of the VAT resources entered in the budget, that is the amount resulting from the application to an estimated base of a VAT call-in rate determined by the budget of the Communities.

In accordance with Article 10(4) of the same regulation, these payments of twelfths are regularized following the transmission to the Commission by the Member States of the statement of the total final amount relating to transactions for which tax has become chargeable during a year. Article 10(1) of Regulation No. 2892/77 as amended requires that this statement be sent before 1 July of the year following the calendar year to which it refers and adds that it must contain all the relevant figures used to determine the base which are required for control purposes.

52. The annual statements are the keystone of the VAT own resources system. From a budgetary point of view, they permit calculation of the difference between VAT own resources payments made by the Member States during a given year and the final amount which results from applying the VAT rate fixed by the Community budget to the final VAT bases of each of the Member States.

They also constitute the only proof of the VAT own resources base in each of the Member States and the controls provided for by Article 12 of Regulation No. 2892/77 as amended, which may lead to amendments of the bases (Article 12(3)), are based upon them.

The statements and the resulting control reports provide the only complete description of how VAT own resources bases are constituted.

53. The annual statements of the VAT own resources bases are normally checked during a single control visit undertaken each year by the administration of the Member State and the Commission. The Directorate-General for Budgets is responsible for the Commission's team, but the Statistical Office of the European Communities, the Directorate-General for Financial Institutions and Taxation and the Directorate-General for Financial Control are also represented.

The purpose of the control is clearly set out in Article 12 of Regulation No. 2892/77 as amended which states that it shall cover the correctness of the operations to centralize the assessment basis, total net VAT revenue collected and determination of the weighted average rate and ensure that the calculations to determine the various compensations are in line with Regulation No. 2892/77. The only inspection as such covers the centralization of returns or revenue; in all other cases what is considered is ways of solving the various problems which arise.

By contrast with the inspections of traditional own resources, these controls are organized by the national authorities specifically to check on the establishment of the VAT base, a procedure which is required only for community purposes.

54. Council Regulation (EEC, Euratom, ECSC) No. 165/74 of 21 January 1974 determining the powers and obligations of officials appointed by the Commission, which applies to VAT control visits by virtue of Article 12(2) of Regulation No. 2892/77 as amended, provides in particular that after every control visit the Commission shall draw up a report setting out its results within two months. The Member State has two months in which to make known its comments to the Commission, which then produces a summary document, setting out the corrections accepted by the Commission and the Member State and the points on which agreement has not yet been reached.

The three documents, which constitute the control report, are then sent to the Advisory Committee on Own Resources, whose discussions offer an opportunity for a useful comparison between the various national procedures and for pointing the way towards solutions to problems. They also permit useful discussion on follow-up action to be taken by the Commission and the Member States.

55. Even the amended version of Regulation No. 2892/77 could not resolve all the problems of implementation. Discussions within the ACOR on control reports or papers on specific problems prepared by the Commission have made a useful contribution to the implementation of the Community's system of own resources.

By autumn 1984 the Committee had held 29 meetings since it first met in June 1979. Besides considering the annual control reports, these have covered Commission decisions on the authorizations and solutions provided for by Articles 5 and 9 of Regulation No. 2892/77 as amended (see para. 66 et seq. below) and the discussion of working papers, most of which have subsequently provided guidelines for the implementation of certain specific provisions of Regulation No. 2892/77. These include, by way of example:

- the practical and legal consequences of failure to respect the deadlines laid down by Regulation No. 2892/77;
- the interpretation of financial rules as regards VAT;
- the layout of the statement and the periods to be taken into consideration;
- the treatment of small firms;
- the calculation of the right to deduct in respect of cars for business use;
- the exchange rates to be used;
- the corrections to be made following controls;
- the correction of errors and adjustments to data;
- evaluation of the base from statistical data;
- the problem of calculating the weighted average rate;
- the treatment of flat-rate farmers;
- the calculation of certain compensations.

56. Corrections to the base following a control can be carried out in a number of ways. The simplest is obviously an agreement between the Member State and the Commission on the nature and amount of the correction to be made either immediately, during the control, or at a later date, after the control report has been written or submitted to the ACOR.

Article 10b of Regulation No. 2892/77 as amended provides for corrections to be incorporated in an aggregate statement showing the situation at 30 June. In general, adjustments to the amounts payable as a consequence of these corrections are combined with the adjustments made following receipt of the definitive statements, that is with the August payment. The possibility of early adjustment, as provided for in the revision of Regulation No. 2891/77, is still being discussed by the Council.

57. If the Commission and the Member State disagree, it is up to the Commission to take steps in order to ensure the correct application of Community rules and to initiate, if necessary, the infringement procedure of Article 169 of the EEC Treaty against the Member State.

In 1984, in respect of twelve cases of infringement of the Sixth VAT Directive, the Commission wrote to the Member States concerned, asking them to pay to the Community budget the own resources due. In the cases where the answers were not satisfactory, the Commission initiated the formal infringement procedure. A similar procedure is in course for three cases in which the Commission believes that the implementation by certain Member States of Regulation No. 2892/77 had been made incorrectly.

58. Leaving aside the question of the sums involved, the above account clearly demonstrates the importance the controls have assumed for the correct implementation of Regulation No. 2892/77. Control visits provide an opportunity for representatives of the national departments concerned with the calculation of the VAT base and Commission officials to meet and clear up any problems they encounter and discuss the methods used. The comparisons made in the ACOR and the summary situations produced further enhance this methodological aspect which supplements the more traditional purpose of a control.

59. A measure of the impact of controls in terms of amounts involved is provided by the total corrections made by 30 June 1984 to bases for previous years as contained in the annual statements submitted under Article 10. Not all these corrections were the result of controls, however; some of them were effected spontaneously by the Member State, sometimes several months after the annual statement had been sent. Subject to this proviso, total corrections to the base at present stand at:[7]

1979 base: 6 900 million ECU (about 1.1% of the original base)
1980 base: 29 600 million ECU (2.8%)
1981 base: 6 700 million ECU (0.6%)
1982 base: 3 300 million ECU (0.3%).

60. It will be seen that one of the consequences of the difficulties of implementing Regulation No. 2892/77 has been an increase in the number of corrections required for a given year. The time taken to make the corrections is gradually shortening since in 1984 no further corrections were made to the 1979 base except for one Member State and the 1980 base was corrected only for five Member States. In any event, the amounts of the corrections are diminishing as the year in question recedes and the number of unresolved problems declines.

Corrections to bases after a number of years are an inherent part of the own resources system; it should also be noted that the procedures referred to in para. 57 will, when completed, lead to corrections to comparatively old bases.

61. The final aspect of VAT base controls which should be included in this report is that of fraud, one which Parliament has mentioned on a number of occasions and particularly in its resolution of 10 April 1984 on frauds against the Community budget (the Gabert resolution). Here a certain amount of caution is required.

In the first place, it should be noted that the own resources system, and Regulation No. 2892/77 in particular, bases the Community's VAT own resources on the returns made to national administrations or the revenue they collect and that the Commission's powers of verification extend only to this stage of the procedure. Since the bulk of the VAT collected goes to the Member States, it is they who have the greatest interest in seeing that it is collected in full.

62. The Commission cannot, however, ignore this aspect, which it included in its proposal for a Council Regulation (EEC) on the measures to be taken in the event of irregularities affecting the own resources referred to in the Decision of 21 April 1970 and the organization of an information system for the Commission in this field. The Council has not yet taken a decision on this proposal, which dates from March 1979, and in February 1984 the Commission asked it to resume examination of it.

The Commission is now considering whether it can investigate VAT frauds in the Member States, as requested by Parliament in the resolution referred to above.

63. These investigations will not, however, have the practical effect which Parliament seems to desire when it says "on the basis of which the Community's share (of the proceeds of VAT) levied in each Member State could be revised." Such an approach goes far beyond the possibilities given by the actual rules and is even contradictory to its philosophy and would, in the Commission's view, undermine the fiscal nature of Community VAT and, by adding a further correction to the returns by taxable persons or national revenue, tend to turn it into a financial contribution. It would, in any case, further complicate the existing system. In practice, permanent investigation of VAT fraud implies a substantial increase in the staff of the Commission departments now engaged in controls.

3.4 Corrections to the base and to revenue

The varying national situations and the exemptions allowed by the Sixth VAT Directive mean that corrections have to be made to the returns made by taxable persons or to the revenue collected by the Member State. These are small in amount and apply more or less equally to both methods of determining the VAT base. Most of the calculation problems which they raise have been resolved.

64. The definitive VAT own resources base to which the rate fixed by the Community budget must be applied is determined either from the intermediate base derived from returns made by taxable persons (method A) or from the net receipts collection by the Member States (method B). In the second case, an intermediate base is derived from the calculation and application of the weighted average rate.

The derogations provided by the Sixth VAT

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[7] These figures take no account of whether the correction increased or decreased the base.

Directive and special national circumstances, for instance of an administrative or geographical nature, mean that both the intermediate bases and net receipts must be corrected so as to place every Member State in the same position from the point of view of the collection of own resources.

The calculation of these corrections for the two methods is set out in more detail in Annex IV but the two main features may be mentioned here.

65. First the corrections should be precisely defined. They have only one purpose, to reconstitute the VAT own resources base in the form which it would have had if a fully harmonised VAT system had been applied uniformly in all the Member States. Since the national situations differ, the procedures for doing this must also differ. Each Member State must undertake different operations to calculate its VAT base because each national system diverges in different ways from the harmonized system, which is still the common goal.

Secondly, while methods A and B require their own corrections, many of these corrections are also common to both methods and arise directly from the derogations and exceptions permitted by the Sixth VAT Directive.

66. Regulation No. 2892/77 as amended provides for compensations to be carried out in a number of ways:

- the Member State may use suitable data to arrive at a precise figure for the compensation. Regulation No. 2892/77 refers to this as a solution;
- the Member State may use estimates to calculate certain stages. The regulation refers to this as an authorization to use approximate estimates;
- the Member State is unable to make even an approximate estimate and may be authorized to ignore the operation. The regulation refers to this as an authorization not to take into account.

The relevant decisions are taken by the Commission at the request of the Member State concerned and after the Advisory Committee on Own Resources has been consulted. In 1983 there were 66 solutions and authorizations to use approximate estimates in force and 20 authorizations not to take into account. Such decisions were taken annually until 1983 but are now valid for three years unless national rules change.

67. The largest group of compensations, from the point of view of the number of operations, the calculations to be made and their impact on the base, are those arising from Annex E (transactions which may continue to be taxed although they should be exempt) and Annex F (transactions which may continue to be exempt although they should be taxed) to the Sixth VAT Directive.[8]

The Sixth Directive originally authorized these derogations for a period of five years from the date when it came into force. On 17 January 1983 the Commission sent the Council a report on the use made by the Member States of these derogations and the difficulties which ending them would pose. On the basis of this report and the first report on the application of the common system of value added tax presented under Article 34 of the Sixth VAT Directive, on 4 December 1984 the Commission sent the Council a proposal for an Eighteenth Directive laying down a timetable for the gradual termination of these derogations. The process would extend to 1 January 1988 and certain derogations would remain in force until the next review, scheduled for 1989.

68. A further series of compensations must be calculated for the restriction of the right to deduct in respect of motor vehicles and oil products. Here too, the transitional period laid down by the second subparagraph of Article 17(6) and Article 17(7) of the Sixth VAT Directive is still in force.

Harmonization of the VAT base will not be complete and the system of compensations will have to be retained until all the derogations have been eliminated.

3.5 Weighted average rate

The weighted average rate is central to calculating the VAT own resources base by the revenue method and its calculation is a complex operation needing a large volume of non-fiscal data. Although substantial progress has been made since 1979, some problems still exist.

69. The revenue method (method B) is described in Articles 6, 7 and 8 of Regulation No. 2892/77 as amended, which states that the VAT own resources base shall be calculated by dividing the total net VAT revenue collected by a Member State by the rate at which VAT was levied during that year.

70. Although the principle is simple, the method is complicated by the fact that virtually all the Member States have more than one VAT rate, and changes are sometimes made during the year. The situation in *1983* was as follows:

VAT rates in the Member States (%)
Belgium:
0 – 6 – 17 – 19 – 25

Denmark:
0 – 22

Germany:
up to 1 July 1983: 6.5 – 13
from 1 July 1983: 7 – 14

France:
5.5 – 7 – 18.6 – 33.3

Ireland:
up to 1 March: 0 – 18 – 30
from 1 March: 0 – 23 – 35

Italy:
0 – 2 – 8 – 10 – 15 – 18 – 20 – 38

Luxembourg:
up to 1 July: 2 – 5 – 10
from 1 July: 6 – 12

Netherlands:
4 – 18

United Kingdom:
0 – 15

Additionally, the real value of these rates is further influenced by reductions in the taxable amount.

71. Because of the multiplicity of rates, Regulation No. 2892/77 as amended provides that, where several VAT rates are applied, the VAT own resources base shall be determined by dividing total net VAT revenue collected by the average rate of VAT weighted as provided for in Article 7.

The weighted average rate is central to method B; it is not therefore surprising that the bulk of the amendments made to the initial version by Regulation No. 3625/83 affected Article 7 of Regulation No. 2892/77.

The weighted average rates in the Member States in 1983 according to their statements sent by 30 June 1984, and so before control, are given below for information. (In accordance with Article 6 of Regulation No. 2892/77, this rate is expressed per hundred currency units and rounded to four decimal places.)

Belgium:	15.0084%
Denmark:	22.0000%
Germany:	12.0186%
France:	16.2965%
Italy:	12.3714%
Luxembourg:	8.3668%
Netherlands:	14.0281%
United Kingdom:	9.3780%

72. Besides the fact that it is central to method B, the weighted average rate merits special attention in this report for two reasons. The first is that it affects the size of the own resources base very considerably. For example, if a Member State has VAT revenue totalling 50,000 million ECU, a weighted average rate of 13.00% will give a base of 384,615 million ECU and so a 1% VAT own resources rate will yield 3,846 million ECU. A 1% increase in the weighted average rate, to 13.13%, would involve a reduction of 40 million ECU of VAT own resources (at the rate of 1%). Secondly, calculation of the weighted average rate requires data from the national accounts and statistics which are not exclusively fiscal in nature. This means that it involves something which is foreign to the VAT system and its use in this system is one of the major questions posed by method B.

The main characteristics of the calculation of the rate and the chief problems which they raise are set out below; further details are given in Annex IV.

73. The basic principle of the calculation is the breakdown among the various rates used of all the transactions giving rise to the collection of non-deductible VAT and hence to net revenue collected by the Member State (Article 7.1). This breakdown is carried out separately for the following categories (Article 7.2):

- final consumption of households and intermediate consumption by private non-profit institutions;
- intermediate consumption by other sectors;
- gross fixed-capital formation of public administrations;
- gross fixed-capital formation of other sectors;
- building land;

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[8] Annex G (the right of option) is no longer applicable.

- consumption on the farm by flat-rate farmers and their direct sales to final consumers.

Transactions are broken down by category on the basis of data from national accounts prepared in accordance with the system of integrated economic accounts (ESA). Subject to some exceptions, the version of the accounts used is that for the penultimate year preceding the one for which the rate is calculated (Article 7.4). If necessary, such data may be supplemented by data taken from sources other than the ESA, particularly internal national accounts, or, in the absence of such accounts, from any other appropriate source (Article 7.5).

74. This means that, because of the time required to prepare the accounts and related data, the VAT legislation for the year in question (year n) is being applied to national accounts, possibly supplemented, for year n – 2. Since consumption patterns remain relatively stable in the short term, this method, imposed by practical constraints, may be considered acceptable.

However, the provisions as a whole raise a number of questions relating to the nature and appropriateness of the data used.

75. National accounts were not designed for fiscal purposes and so the breakdown of the transactions they contain by VAT rate involves approximations based on other sources; the extent of these approximations increases with the complexity of the VAT rate structure.

In any case, not all the Member States prepare their national accounts on the ESA model and if the Statistical Office of the European Communities gets an ESA model of their accounts, internal accounts must be used in order to obtain a certain level of detail. The difficulties involved are, however, practical ones of reconciling the different versions rather than genuine problems of principle.

In addition, it must be pointed out, that the difficulties in implementing method B are raised by the approximations. More the VAT number of VAT rates in a Member State is high, more the approximations are important and less reliable.

76. All the Member States which use method B do so on the basis of national accounts from year n – 2, with the exception of one, which has to use accounts from year n – 3. The supplementary data may, however, be older.

77. The first revision of Regulation No. 2892/77 resolved the problem of how to cope with rate changes during a year. Regulation No. 3625/83 states that transactions in respect of which the rate has been changed shall be allocated to the old and new rates pro rata temporis, with account being taken of the average period of time elapsing between the entry into force of the new rate and the collection of revenue resulting therefrom (Article 7.7).

This provision both clarifies the series of calculations to be undertaken when rates change and links the transactions more closely with the revenue which they generate.

78. Finally reference should be made to the differences in administrative organization between Member States, for these influence the way the weighted average rate is calculated and the ease with which controls can be conducted. In two Member States (Luxembourg and the Netherlands) the rate is calculated by the national statistical office while in the others it is the responsibility of the finance ministry, assisted to a varying extent by the national statistical office. Germany is one exception, the calculation has been carried out by a private institute under contract to the finance ministry.

3.6 Conclusion

In view of the choices made by the Member States as regards the method of calculating the VAT own resources base, the position with regard to the own resources rules in general and the failure to achieve the harmonization aimed at by the VAT directives, the Commission is proposing that Regulation No. 2892/77 be extended for three years (see 2.6). An appropriate proposal for a regulation is contained in the second part of this document.

79. The transitional period for the system of collecting VAT own resources should come to an end in 1985. However, the choice of a definitive method is beset by two types of difficulties, one relating to the system and the other to the nature of the rules.

80. The above account has shown that the entire structure of financial and fiscal regulations is in the process of change. The basic regulation, Regulation No. 2891/77, is being amended and so is the Financial Regulation.

The common system of value added tax and the uniform base have not been achieved, there are still many possibilities for derogations and in the past Parliament itself has recognized the link between the continued existence of these derogations and the transitional period for VAT own resources. A significant progress could be achieved by adoption of the Eighteenth Directive abolishing certain derogations provided for in the Sixth Directive, proposal actually being examined in the Council.

More generally, the changing nature of the Community's system of own resources and not just of Regulation No. 2891/77, is underlined by the situation that will be created by amendment of the Decision of 21 April 1970 on the replacement of financial contributions from the Member States by the Communities' own resources, and in particular the possibility for budgetary imbalances to be corrected by adjustments to VAT revenue, and by the impending accession of two new Member States, which, in the near future, will both be paying VAT own resources.

81. Regulation No. 2892/77 was amended at the end of 1983 and the Commission received the first year's statements prepared under it in July 1984. Only in 1985 will these be controlled and the problems they raise discussed.

In December 1983 the Council's Fifteenth VAT Directive authorized Greece to delay the introduction of the common system of VAT, and hence the payment of VAT own resources, to 1 January 1986.

82. More fundamentally, all the Member States with one exception have chosen the least direct method, method B, while both the Commission and Parliament have always held the view that method A not only provided a means of calculating VAT own resources payments, but also met the aim of introducing a real new own resource for the Community.

83. In the circumstances, the Commission considers that it would be premature at this stage to present a proposal involving a choice between the two methods. It believes more time is needed to prepare a definitive method in view of uncertainties concerning rules and the present choice made by the Member States.

It therefore proposes that the transitional period be extended by three years, to the end of 1988, and sends the Council and Parliament a proposal to this effect.

The Commission's aim is to arrive at a single method. A report and proposal for a regulation will be presented by December 1987, so that a decision can be taken in the first half of 1988.

ANNEX I: REFERENCES

A. Regulations and reports

Own resources system

- Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources.
  - Publication: OJ L 94, 28 April 1970, p. 19.
  - Proposal for a Council Decision on the Communities' system of own resources: OJ C 145, 3 June 1983, p. 5 (COM(83)270 of 5 May 1983).
  - Opinion of the European Parliament: OJ C 342, 19 December 1983, p. 31.
  - Amended proposal for a Council Decision on the Communities' system of own resources: OJ C 193, 21 July 1984, p. 5 (COM(84)384 of 9 July 1984).
- Council Regulation (EEC, Euratom, ECSC) No. 2/71 of 2 January 1972 implementing the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources.
  - Publication: OJ L 3/71, 5 January 1971, p. 1.
- Council Regulation (EEC, Euratom, ECSC) No. 2891/77 of 19 December 1977 implementing the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources.
  - Publication: OJ L 336, 27 December 1977, p. 1.
  - Report on the implementation of and proposal amending Regulation No. 2871/77: OJ C 231, 4 September 1982, p. 15 (COM(82)316 of 20 July 1982).

BELGIUM

Estimate of VAT own resources base

	CRONOS	million Bfrs. 1980	1981	1982
– Final consumption of households on the economic territory	S1011000	2 146 206	2 295 534	2 511 147
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	220 158	245 936	269 040
Domestic services (46)	Z7037100	40 830	42 732	46 750
Services of physicians (53)	Z7043100	88 151	96 494	105 560
Hospital care (54)	Z7044100	75 404	81 892	89 580
Accident and health insurance services (55)	Z7045100	614	688	750
Communication (64)	Z7052100	18 719	20 094	21 980
Education (74)	Z7059100	:	:	:
Financial services, n.e.c. (85)	Z7067100	46 223	48 982	53 580
– Balance A		1 656 107	1 758 716	1 923 907
Intermediate consumption				
– General government	A6021200	139 748	150 301	154 308
– Private non-profit institutions	A7021200	:	:	:
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		6 740 •	7 010 •	7 580
Services of credit institutions (690=69A=69B)		46 720 •	48 530 •	52 510
Services of renting (730)		23 060 •	23 960 •	25 930
Services of education (750)		:	:	:
Market services of health (770)		35 941 •	37 340 •	40 400
Total B		252 209	267 141	280 728
Gross fixed capital formation				
– General government	A6021410	125 662	132 030	135 901
– Private non-profit institutions	A7021410	:	:	:
– Other branches exempt from VAT (NACE/CLIO classification R 25)	[2]			
Communication (67)	Z5026100	18 434	18 998	19 690
Credit institutions (69A)	Z5027100	12 665	12 916	13 380
Other market services (74)	Z5029100	264 837	178 996	185 490
Total C		421 598	342 940	354 461
Total base including VAT (A+B+C)	—	2 329 914	2 368 797	2 559 096
VAT to be deducted	A0112210	255 511	278 548	295 292
Total base excluding VAT	—	2 074 403	2 090 249	2 263 804

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1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating .rate.
2. GFCF by branch of ownership
S = SEC 1 Z= ZCN2 A = AMP1.

• Statistical Office estimate.

○ First amendment to the proposal amending Regulation No. 2891/77: OJ C 146, 4 June 1983, p. 4 (COM(83)254 of 10 May 1983).

○ Second amendment to the proposal amending Regulation No. 2891/77: OJ C 303, 10 November 1983, p. 19 (COM(83)621 of 21 October 1983).

○ Third amendment to the proposal amending Regulation No. 2891/77: OJ C 219, 21 August 1984, p. 7 (COM(84)465 of 31 July 1984).

● Council Regulation (EEC, Euratom, ECSC) No. 2892/77 of 19 December 1977 implementing in respect of own resources accruing from value added tax the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources.

○ Publication: OJ L 336, 27 December 1977, p. 8.

○ Proposal amending Regulation No. 2892/77: OJ C 200, 4 August 1982, p. 12 (COM(82)412 of 9 July 1982).

● Council Regulation (EEC, Euratom, ECSC) No. 3550/82 of 28 December 1982: OJ L 373, 21 December 1982, p. 1.

● Amendment to the proposal for a Regulation amending Regulation No. 2892/77: OJ C 67, 12 March 1983, p. 6 (COM(83)101 final of 1 March 1983).

● Council Regulation (EEC, Euratom, ECSC) No. 3625/83 of 19 December 1983 amending Regulation No. 2892/77: OJ L 360, 23 December 1983, p. 1.

VAT

● Sixth Council Directive (77/338/EEC) of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment: OJ L 145, 13 June 9177, p. 1.

● First report from the Commission to the Council on the application of the common system of value added tax, submitted in accordance with Article 34 of the Sixth Directive (77/388/EEC) of 17 May 1977 (COM(83)426 final of 14 September 1983).

● Report from the Commission to the Council on the transitional provisions applicable under the common system of VAT, submitted in accordance with Article 28 of the Sixth Council Directive of 17 May 1977 (COM(82)885 final).

● Report from the Commission to the Council submitted in accordance with Article 24, paragraph 8 of the 6th Council Directive of 17 May 1977 (Harmonization of laws relating to turnover taxes).
Description, analysis and suggestions for the harmonization of national schemes for small undertakings (Situation as at 31.12.1982) (COM(83)748 final).

● Report from the Commission to the Council – Proposals for improving and adjusting the arrangements introduced by certain Member States under the Common flat-rate scheme for farmers (COM(83)435 final).

● Proposal for an eighteenth Council Directive on the harmonization of the laws of the Member States relating to turnover taxes – abolition of certain derogations provided for in Article 28(3) of Directive 77/388/EEC – common system of value added tax. OJ No. C 347, 29.12.1984.

● Proposal for a nineteenth Council Directive on the harmonization of the laws of the Member States relating to turnover taxes, amending Directive 77/388/EEC – common system of value added tax. OJ No. C 347, 29.12.1984.

Controls and irregularities

● Council Regulation (EEC, Euratom, ECSC) No. 165/74 of 21 January 1974 determining the powers and obligations of officials appointed by the Commission pursuant to Article 14(5) of Regulation (EEC, Euratom, ECSC) No. 2/71: OJ L 20, 24 January 1974, p. 1.

● Proposal for a Council Regulation (EEC) on the measures to be taken in the event of irregularities affecting the own resources referred to in the Decision of 21 April 1970 and the organization of an information system for the Commission in this field.

○ Publication: OJ C 88, 4 April 1979, p. 4.

- ○ Communication from the Commission to the Council on the resumption of consideration of the proposal: (COM(84)58 of 10 February 1984).

- ● Council Regulation (EEC) No. 1468/81 of 19 May 1981 on mutual assistance between the administrative authorities of the Member States and cooperation between the latter and the Commission to ensure the correct application of the law on customs or agricultural matters: OJ L 144, 2 June 1981, p. 1.

- ● Council Directive of 15 March 1976 on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties, and in respect of value added tax (76/308/EEC): OJ L 73 of 19 March 1976, p. 18. The Directive was amended by the Council Directive of 6 December 1979: OJ L 331, 27 December 1979, p. 10.

Customs duties

- ● Council Regulation (EEC) No. 1430/79 of 2 July 1979 on the repayment or remission of import or export duties: OJ L 175, 12 July 1979, p. 1.

- ● Council Regulation (EEC) No. 1697/79 of 24 July 1979 on the post-clearance recovery of import duties or export duties which have not been required of the person liable for payment on goods entered for a customs procedure involving the obligation to pay such duties: OJ L 197, 3 August 1979, p. 1.

- ● Council Directive 78/453/EEC of 22 May 1978 on the harmonization of provisions laid down by law, regulation or administrative action concerning deferred payment of import duties or export duties: OJ L 146, 25 June 1978, p. 19.

- ● Council Directive 79/623/EEC of 25 June 1979 on the harmonization of provisions laid down by law, regulation or administrative action relating to customs debt: OJ L 179, 17 July 1979, p. 31.

B. Resolutions adopted by the European Parliament

Resolution of the European Parliament closing the procedure for consultation on the proposal for a Regulation amending Regulations No. 2891/77 and No. 2892/77: OJ C 13, 17 January 1983, p. 218.

(Parliament)
"3. expects the Commission to submit a further report by 31 December 1984 on the implementation of the regulations relating to own resources and to cover in that report all the aspects which have a decisive bearing on the choice of the definitive method for the calculation of the VAT base, with particular reference to the additional burdens which arise for the taxpayer and public control bodies as a function of the method of determining the base.

4. hopes that on this occasion a report will also be submitted on the way in which the law resources of the Community are shown in the national budgetary documents and accounts and on the compatibility thereof with the financial autonomy of the Community."

DENMARK

Estimate of VAT own resources base

			million Dkr.	
	CRONOS	*1980*	*1981*	*1982*
– Final consumption of households on the economic territory	S1011000	208 637	232 184	257 980
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	39 386	43 561	48 400 *
Domestic services (46)	Z7037100	882	1 001	1 110 *
Services of physicians (53)	Z7043100	1 151	1 367	1 520 *
Hospital care (54)	Z7044100	267	296	330 *
Accident and health insurance services (55)	Z7045100	247	371	410 *
Communication (64)	Z7052100	2 711	2 996	3 330 *
Education (74)	Z7059100	2 580	3 144	3 490 *
Financial services, n.e.c. (85)	Z7067100	2 146	2 262	2 510 *
– Balance A		159 267	177 186	196 880
Intermediate consumption				
– General government	A6021200	34 185	39 264	44 940 *
– Private non-profit institutions	A7021200	:	:	:
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		1 990 *	2 190 *	2 510 *
Services of credit institutions (690=69A=69B)		2 980 *	3 270 *	3 740 *
Services of renting (730)		6 850 *	7 530 *	8 610 *
Services of education (750)		100 *	100 *	120 *
Market services of health (770)		510 *	560 *	640 *
Total B		46 615	52 914	60 590
Gross fixed capital formation				
– General government	A6021410	12 809	12 031	14 170 *
– Private non-profit institutions	A7021410	:	:	:
– Other branches exempt from VAT (NACE/CLIO classification R 25)	[2]			
Communication (67)	Z5026100	[3] 28 120 *	26 300 *	30 970 *
Credit institutions (69A)	Z5027100			
Other market services (74)	Z5029100			
Total C		40 929	38 331	45 140
Total base including VAT (A+B+C)	—	246 811	268 431	302 610
VAT to be deducted	A0112210	37 728	41 719	47 020[4]
Total base excluding VAT	—	209 083	226 712	255 590

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1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating rate.
2. GFCF by branch of ownership
   S = SEC 1 Z= ZCN2 A = AMP1.
3. Estimate based on the ratio 0.4 of GFCF.
4. Estimate base on the rate of increase of the VAT base.

* Statistical Office estimate.

Resolution of the European Parliament closing the discharge procedure in respect of the 1981 financial year: OJ L 174, 30 June 1983, p. 21:

(Parliament)
"1. recalls its resolution of 17 December 1982 on the amending and extending of Regulations 2891/77 and 2892/77, and wishes in particular to stress paragraphs 4, 6 and 7 thereof; similarly, in the transition period where two methods of determining the VAT base continue to be permitted, the Commission should pay particular attention to harmonization and to the accuracy of the national accounting systems of the Member States; in this connection the Commission and the Court of Auditors are urgently requested to find a solution to the problems that have hitherto prevented them from examining the relevant statistics."

Resolution of the European Parliament on

GERMANY

Estimate of VAT own resources base

			million DM	
	CRONOS	*1980*	*1981*	*1982*
– Final consumption of households on the economic territory	S1011000	895 850	943 290	972 330
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	104 430	121 420	114 850•
Domestic services (46)[4]	Z7037100	7 970•	8 390•	8 650•
Services of physicians (53)[3]		123 900	133 400	137 510•
Hospital care (54)[3]	Z7044100			
Accident and health insurance services (55)[3]	Z7045100			
Communication (64)	Z7052100	14 500	15 180	15 650•
Education (74)[4]	Z7059100	2 690•	2 830•	2 920•
Financial services, n.e.c. (85)[4]	Z7067100	4 730•	4 980•	5 130•
– Balance A		637 630	667 090	687 620
Intermediate consumption				
– General government	A6021200	74 250	79 070	82 830
– Private non-profit institutions	A7021200	11 210	12 030	12 800
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		3 740•	3 890•	4 040•
Services of credit institutions (690=69A=69B)		19 420•	20 220•	20 960•
Services of renting (730)		23 510•	24 480•	25 370•
Services of education (750)		370•	380•	390•
Market services of health (770)		11 480•	11 950•	12 390•
Total B		143 980	152 070	158 780
Gross fixed capital formation				
– General government	A6021410	52 390	49 740	45 570
– Private non-profit institutions	A7021410	5 130	5 470	5 450
– Other branches exempt from VAT (NACE/CLIO classification R 25)	2			
Communication (67)	Z5026100	8 540•	8 550•	8 290•
Credit institutions (69A)	Z5027100	5 420•	5 460•	5 260•
Other market services (74)	Z5029100	144 310•	144 410•	140 000•
Total C		215 790	213 630	204 570
Total base including VAT (A+B+C)	—	997 400	1 032 790	1 050 970
VAT to be deducted	A0112210	96 450	100 690	101 320
Total base excluding VAT	—	900 950	932 100	949 050

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1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating rate.
2. GFCF by branch of ownership
   S = SEC 1 Z= ZCN2 A = AMP1.
3. Including medicines and therapeutic equipment.
4. Figures not available for Germany; estimates based on France.

• Statistical Office estimate.

action taken on the observations accompanying the discharge decision for 1981: OJ C 77, 19 March 1984, p. 157:

(Parliament)
"5. notes that the Commission is to devote particular attention to the following points:

(a) harmonization of the basis for VAT assessment:
The efforts in this field to eliminate, in agreement with the Member States, the shortcomings of the statistical systems as soon as possible are to be continued, with the aim avoiding possible repercussions on the Community's own resources;"

Opinion of the European Parliament on the second amendment to the proposal for a Regulation amending Regulation No. 2891/77: OJ C 172, 2 July 1984, p. 145:

(Parliament)
"5. views that these proposals as emergency measures designed to rectify certain shortcomings observed in the collection of own resources; takes note of the Commission's undertaking to revitalize the process of harmonizing national laws with a view to the uniform application of the system of own resources and requests the Commission to submit by the end of June 1985 a report detailing the progress made and the measures still to be taken in this field;"

Opinion of the European Parliament on the proposal for a Council Regulation (EEC) on the measures to be taken in the event of irregularities affecting the own resources referred to in the Decision of 21 April 1970 and the organization of an information system in this field: OJ C 140, 5 June 1979, p. 147.

Resolution adopted by the European Parliament on 10 April 1984 on frauds against the Community budget: OJ C 127, 14 May 1984, p. 52.

ANNEX II: TREATMENT OF OWN RESOURCES IN THE BUDGET DOCUMENTS AND NATIONAL ACCOUNTS OF THE MEMBER STATES

A. Budget documents

1. Four Member States include the Communities' own resources in the revenue side of their budget before entering transfers to the Community budget on the expenditure side.

- Greece, which pays only customs duties, agricultural and sugar levies as own resources. Since it has been authorized not to introduce VAT until 1 January 1986, Greece will pay a financial contribution up to that date.
- Ireland, where a note attached to the estimates of revenue and expenditure explains the own resources system.
- Italy, where the Communities' own resources have a special heading in the revenue entered in the national budget and where the amount paid to the Community appears in the expenditure of the Treasury Ministry marked "compulsory expenditure".
- The United Kingdom, where the revenue entered in the budget includes the Communities' own resources with this point being mentioned for customs duties and agricultural levies which appear under a specific heading. The amount of own resources paid to the Communities is included in the net payments to the Community budget contained in the chapter "Overseas aid and other overseas services".

Both Greece and the United Kingdom provide notes and tables explaining all financial relations with the Communities.

2. In the other six Member States, pay-

ments to the Community budget are not included in expenditure. However, the Communities' own resources are shown in budget documents in various ways, allowing three groups of countries to be distinguished.

3. In Denmark and France, the Communities' own resources are first included in State revenue before being deducted; the Finance Act thus presents a total net of payments to the Community budget. In Denmark, this is done by including the gross yield of taxes raised in the body of the Finance Act and subtracting Community revenue as "negative revenue". In France, total revenue in the Finance Act is adopted net after elimination of revenue made over, including the Communities' own resources which are contained in the section "Payments from State revenue to the European Communities" in the "Table of Ways and Means" annexed to the Finance Act.

4. In Belgium and the Netherlands the revenue entered in the budget does not include own resources. The total of customs duties and VAT own resources is indicated for information purposes in the ways and means budget in Belgium and in the statement of means in the Netherlands. The agricultural and sugar levies are indicated in an annex to the agriculture budget (Fonds agricole/Landbouwfonds in Belgium and Landbouwegalisatiefonds in the Netherlands).

5. In the Federal Republic of Germany and in Luxembourg the revenue entered in the budget is only that actually available to the State and does not therefore include the Communities' own resources, which are set out for information purposes in an annex to the general finance chapter in Germany and to the revenue and expenditure budget in Luxembourg.

B. National accounts

Section 215[10] of the European System of Integrated Economic Accounts (ESA) states that where an institutional unit carries out distributive or financial transactions on behalf of another institutional unit, these transactions should be recorded once only, in the accounts of the latter. Section 419 lists the taxes linked to production and imports paid to the institutions of the European Communities. Accordingly Statistical Office publications concerning the national accounts show amounts collected for the European institutions not as a transfer by general government to the rest of the world but as resources of the institutions of the European Communities; the amount of taxes linked to production and imports entered as resources in the distribution of income account of general government[11] is thus the net amount excluding payments to the Community institutions, which are contained in a separate account (taxes linked to production and imports paid to the institutions of the European Communities).

FRANCE

Estimate of VAT own resources base

	CRONOS	1980	million Ffrs. 1981	1982
– Final consumption of households on the economic territory	S1011000	1 745 090	2 008 060	2 303 320
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	211 261	248 297	284 810 *
Domestic services (46)	Z7037100	15 526	17 444	20 010 *
Services of physicians (53)	Z7043100	61 580	71 282	81 760 *
Hospital care (54)	Z7044100	110 694	130 547	149 740 *
Accident and health insurance services (55)	Z7045100	5 703	5 662	7 450 *
Communication (64)	Z7052100	17 982	20 353	23 230 *
Education (74)	Z7059100	5 243	5 937	6 810 *
Financial services, n.e.c. (85)	Z7067100	9 215	10 907	12 510 *
– Balance A		1 307 886	1 497 631	1 717 000
Intermediate consumption				
– General government	A6021200	144 283	170 388	199 248
– Private non-profit institutions	A7021200	9 990	11 216	12 591
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		10 520 *	11 820 *	13 510 *
Services of credit institutions (690=69A=69B)		32 510 *	36 520 *	41 740 *
Services of renting (730)		11 140 *	12 510 *	14 300 *
Services of education (750)		5 030 *	5 650 *	6 460 *
Market services of health (770)		34 010 *	38 210 *	43 660 *
Total B		247 483	286 314	331 509
Gross fixed capital formation				
– General government	A6021410	77 512	89 100	101 214
– Private non-profit institutions	A7021410	2 073	2 339	2 631
– Other branches exempt from VAT (NACE/CLIO classification R 25)	2			
Communication (67)	Z5026100	20 924	22 870 *	25 350 *
Credit institutions (69A)	Z5027100	4 908	5 360 *	5 950 *
Other market services (74)	Z5029100	235 670	257 560 *	285 480 *
Total C		341 087	377 229	420 625
Total base including VAT (A+B+C)	—	1 896 456	2 161 174	2 469 134
VAT to be deducted	A0112210	244 666	275 996	324 602
Total base excluding VAT	—	1 651 790	1 885 178	2 144 532

1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating rate.
2. GFCF by branch of ownership
S = SEC 1 Z= ZCN2 A = AMP1.
* Statistical Office estimate.

The current situation in the Member States is as follows:

- Eight Member States treat own resources in accordance with ESA principles (Belgium, Denmark, France, Ireland, Italy, Luxembourg, the Netherlands and the United Kingdom).
- Contrary to what is required by the ESA, Germany continues to present own resources as resources of general government, then as a use of general government under current international cooperation and as resources of the institutions of the European Communities under this heading. The SOEC therefore makes an adjustment when preparing its publications.
- At present the SOEC has only aggregated statistics for Greece which do not show in detail the flows between institutional sectors.

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[10] ESA – Second edition (1979), p. 24.

[11] Item R20 of Table 1 for Sector S60 of the General Government Accounts and Statistics – Eurostat 1983.

IRELAND

Estimate of VAT own resources base

			million IR£	
	CRONOS	*1980*	*1981*	*1982*
– Final consumption of households on the economic territory	S1011000	5 617.6	6 735.0	7 489.0
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	274	329 *	365 *
Domestic services (46)	Z7037100	15	18 *	20 *
Services of physicians (53) Hospital care (54)	Z7043100 Z7044100	45	54 *	60 *
Accident and health insurance services (55)	Z7045100	2	2 *	3 *
Communication (64)	Z7052100	41	49 *	55 *
Education (74)	Z7059100	129	155 *	172 *
Financial services, n.e.c. (85)	Z7067100	69	83 *	92 *
– Balance A		5 042.6	6 045	6 722
Intermediate consumption				
– General government	A6021200	280.4	334.4 *	392.8 *
– Private non-profit institutions	A7021200	:	:	:
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		51.1 *	61.0 *	71.6 *
Services of credit institutions (690=69A=69B)		93.7 *	111.8 *	131.3 *
Services of renting (730)		40.2 *	47.9 *	56.3 *
Services of education (750)		:	:	:
Market services of health (770)		:	:	:
Total B		465.4	555.1	652.0
Gross fixed capital formation				
– General government	A6021410	409.3	551.4	552 *
– Private non-profit institutions	A7021410	:	:	:
– Other branches exempt from VAT (NACE/CLIO classification R 25)	2			
Communication (67)	Z5026100	123.0	150 *	150 *
Credit institutions (69A)	Z5027100	73.0	89 *	89 *
Other market services (74)	Z5029100	699.0	853 *	855 *
Total C		1 304.3	1 643.4	1 646
Total base including VAT (A+B+C)	—	6 812.9	8 243.5	9 020.0
VAT to be deducted	A0112210	470.4	618.0	1 000 *
Total base excluding VAT	—	6 341.9	7 625.5	8 020

1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating rate.
2. GFCF by branch of ownership
   S = SEC 1 Z= ZCN2 A = AMP1.

* Statistical Office estimate.

ANNEX III: ESTIMATING THE VAT OWN RESOURCES BASE FROM NATIONAL ACCOUNTS AGGREGATES

1. In the course of preparatory work within the Council on Regulation No. 3625/83 amending Regulation No. 2892/77, the Commission was asked to present a report to the Council by the end of 1984 assessing the base used for determining VAT own resources, principally in the light of ESA[12] data provided by the Statistical Office of the European Communities.

2. Work in fact began in 1980 and the methodology proposed was put before the Advisory Committee on Own Resources at its 15th meeting under Article 13 of Regulation No. 2892/77 on 25 February 1981. In response to the undertaking it has given, the Commission is presenting in this paper the results of its estimates for the most recent years: 1980, 1981 and 1982.

3. This paper sets out the details of the calculations made by the Statistical Office for all the Member States paying VAT own resources with the exception of Luxembourg, for which the figures available to the Statistical Office are too patchy.

4. The methods used call for several comments. First it must be remembered that the national accounts are produced by aggregating data, calculations and estimates of very varied origins. Similarly these accounts have a specific purpose: to provide figures on domestic economic activity. To use them for any other purpose implies adapting the specific concepts, nomenclatures and data in line with that new purpose. This is possible only if certain assumptions or estimates are made which, in fact, amount to simplifications and must therefore be used with extreme caution.

In particular the exercise described here calls for three general reservations:

- it involves the use of nomenclatures which were not designed for tax purposes and which therefore have to be either supplemented by additional material or treated as approximations. For example, use is made of classifications (the purposes of consumption of households, NACE-CLIO R 44 and R25) which do not give a breakdown between taxable and non-taxable transactions; similarly these transactions are defined for the purposes of the national accounts in terms of elements which differ from those used in the Sixth Directive;
- the national accounts of the Member States have to be drawn up in accordance with the European System of Integrated Economic Accounts (ESA). However, when the ESA is applied to differing national situations the concepts used may sometimes have to be adapted; the basic data, too, may differ on occasions;
- in view of the mismatch between the data available in the national accounts and the purpose of the present exercise, the Statistical Office has had to make a large number of estimates itself (these are indicated in the country tables on pages 326-333). The figures given are the best possible approximation that can be obtained in the light of the information currently available; but they are still more in the nature of an exploratory inquiry rather than an official statistical survey.

5. Subject to these reservations the Statistical Office sets out in the following tables its calculation of the base (exclusive of VAT) in each of the Member States. The calculation is based on the sum of the totals for final consumption by households (less transactions exempted under the Sixth Directive, intermediate consumption by general government and branches exempt from VAT and gross fixed capital formation by general government and branches exempt from VAT.

The results can be assessed in the light of the table below showing the VAT base estimate obtained on the basis of the national accounts as a percentage of the amount of the VAT base communicated by the Member States in their annual statements (taking into account the corrections made up to 30 June 1984):

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[12] European System of Integrated Economic Accounts.

	1980	*1981*	*1982*
Belgium	113,3	109,6	110,9
Denmark	115,4	118,6	120,7
Germany	106,6	105,8	103,9
France	112,3	113,2	110,9
Ireland	109,7	101,3	96,3
Italy	133,6	140,5	145,4
Netherlands	110,0	110,1	113,7
United Kingdom	114,3	125,7	107,6

6. This comparison calls for two main comments:

- In all the Member States (with the exception of Ireland in 1982) the "national accounts" base is higher than the "VAT statement" base. The Commission departments are not yet able to provide a satisfactory general explanation for this phenomenon. However, research is continuing, in particular to determine whether the use of a more detailed nomenclature (which would, however, require a greater number of estimates) might make it possible to distinguish any elements included in the "national accounts" base which should, in fact, be excluded.
- For most of the Member States the discrepancy ranges between 4% and 13% except in the case of Ireland, as noted earlier, and in the case of two Member States where it is higher: Denmark and especially Italy. Here again research will have to continue in order to identify the peculiarities of the national accounting systems that might explain the difference.

7. While presenting these figures at the express request of a number of Member States, the Commission feels bound to stress once again that, at the present stage and with the information currently available, it regards the exercise as an exploratory project that does not provide any genuinely valid information and it therefore holds strong reservations as to the real value of the comparison. In particular this cannot be regarded as an approach that would allow a serious estimate to be made of the question of fraud nor as the outline of a third method of calculating the VAT own resources base.

ITALY

Estimate of VAT own resources base

		thousand million Lire		
	CRONOS	*1980*	*1981*	*1982*
– Final consumption of households on the economic territory	S1011000	212 488	254 661	298 192
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	19 264	22 687	26 570*
Domestic services (46)	Z7037100	1 145	1 140	1 330*
Services of physicians (53)	Z7043100	4 294	5 374	6 290*
Hospital care (54)	Z7044100	733	894	1 050*
Accident and health insurance services (55)	Z7045100	:	:	:
Communication (64)	Z7052100	1 947	2 470	2 890*
Education (74)	Z7059100	746	930	1 090*
Financial services, n.e.c. (85)	Z7067100	597	722	950*
– Balance A		183 762	220 444	258 022
Intermediate consumption				
– General government	A6021200	15 237	19 634	23 923
– Private non-profit institutions	A7021200	:	:	:
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		1 190*	1 410*	1 650*
Services of credit institutions (690=69A=69B)		2 030*	3 470*	4 060*
Services of renting (730)		4 330*	5 130*	6 010*
Services of education (750)		250*	300*	350*
Market services of health (770)		730*	860*	1 010*
Total B		23 767	30 804	37 003
Gross fixed capital formation				
– General government	A6021410	11 509	15 180	19 165
– Private non-profit institutions	A7021410	91	110	120
– Other branches exempt from VAT (NACE/CLIO classification R 25)	2			
Communication (67)	Z5026100	2 558	2 843	3 130*
Credit institutions (69A)	Z5027100	1 130	1 527	1 680*
Other market services (74)	Z5029100	22 792	28 464	31 310*
Total C		38 080	48 124	55 405
Total base including VAT (A+B+C)	—	245 609	299 372	350 430
VAT to be deducted	A0112210	18 345	21 358	25 746
Total base excluding VAT	—	227 264	278 014	324 684

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1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating rate.
2. GFCF by branch of ownership
S = SEC 1 Z= ZCN2 A = AMP1.

* Statistical Office estimate.

ANNEX IV: PROBLEMS OF CALCULATION

A. Compensations

1. Irrespective of whether the VAT own resources base is calculated by method A or method B, the diversity of the VAT systems in the Member States means that corrections – mostly known as "compensations" – have to be made in order to take into account particular national features and to arrive at the situation that would have existed if the Sixth Directive has been fully applied in a uniform manner in all the Member States.

Most of the corrections are the same for both methods, although under method B they may be made either "to receipts" – i.e. before application of the weighted average rate – or "to the base" – i.e. afterwards. Article 8 of Regulation No. 2892/77 as amended makes explicit provision for correction of receipts in only two cases, although it is often more convenient to correct receipts than the intermediate base. At all events, what is essential with method B is that receipts and the weighted average rate should be homogeneous, in other words should relate to precisely the same final purchases.

2. To give some idea of the scale of the compensations the table on page 334 shows them in relation to either gross receipts revenue or the intermediate base. These data are taken from the 1983 VAT base statements, which were sent to the Commission by the end of June 1984, and do not, therefore, yet take account of the results of the controls provided for under Regulation No. 2892/77.

3. There are no fundamental problems as regards the intermediate base obtained by centralizing returns and total receipts, which forms the starting point for calculating the definitive VAT own resources base. At the most there have been occasional difficulties due, for example, to prolonged strikes or computer failures, but these have always been resolved rapidly.

NETHERLANDS
Estimate of VAT own resources base

		million Dfl.		
	CRONOS	1980	1981	1982
– Final consumption of households on the economic territory	S1011000	201 010	209 450	217 880
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	22 030	24 350	25 330 *
Domestic services (46)	Z7037100	1 100	1 140	1 190 *
Services of physicians (53)	Z7043100	7 280	7 640	7 950 *
Hospital care (54)	Z7044100	14 800	16 130	16 780 *
Accident and health insurance services (55)	Z7045100	:	:	:
Communication (64)	Z7052100	2 380	2 490	2 590 *
Education (74)	Z7059100	720	860	890 *
Financial services, n.e.c. (85)	Z7067100	5 320	5 350	5 570 *
– Balance A		147 380	151 490	157 580
Intermediate consumption				
– General government	A6021200	17 120	18 530	19 460
– Private non-profit institutions	A7021200	:	:	:
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		1 060 *	1 120 *	1 160 *
Services of credit institutions (690=69A=69B)		3 650 *	3 820 *	3 980 *
Services of renting (730)		2 660 *	2 790 *	2 900 *
Services of education (750)		750 *	790 *	820 *
Market services of health (770)		3 300 *	3 470 *	3 600 *
Total B		28 540	30 520	31 920
Gross fixed capital formation				
– General government	A6021410	10 970	11 200	10 690
– Private non-profit institutions	A7021410	:	:	:
– Other branches exempt from VAT (NACE/CLIO classification R 25)	[2]			
Communication (67)	Z5026100	1 460	1 400	1 380 *
Credit institutions (69A)	Z5027100	290	290	290 *
Other market services (74)	Z5029100	27 490	25 800	25 450 *
Total C		40 210	38 690	37 810
Total base including VAT (A+B+C)	—	216 130	220 700	227 310
VAT to be deducted	A0112210	24 420	24 950	25 090
Total base excluding VAT	—	191 710	195 750	202 220

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1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating rate.
2. GFCF by branch of ownership
S = SEC 1 Z= ZCN2 A = AMP1.

* Statistical Office estimate.

4. *Under method A* three types of correction have been necessary in order to take account of certain transactions giving rise to refunds, estimated assessments and the imprecision of some returns. All these corrections are calculated on the basis of administrative data, plus other statistics from various sources where necessary.

5. In Ireland the *returns have to be adjusted first* to take account of purchases by diplomatic personnel, fishing equipment (exempt under Article 15(5) of the Sixth Directive) and purchases of goods by foreign enterprises (for which the right of refund exists under Article 17(3)(a) of the Sixth Directive) and the Eighth Directive. These have to be excluded from the VAT base under Article 2(1) and 4(1) of Regulation No. 2892/77 as amended.

6. The second correction is more significant in terms of amounts involved. Under Article 4(3) of Regulation No. 2892/77 the taxable base represented by *estimated assessments* forms part of the VAT own resources base for Member States applying method A. This type of correction has been discussed on many occasions both between the Commission and the Member States and by the ACOR and the original wording had to be modified in 1983 to clarify the concept of estimated assessment, in particular so as to indicate that it applied not only where taxable persons had failed to make any returns, but also where additional assessments were made by the tax authorities. The calculation of the correction also had to be rectified on several occasions owing to the conceptual difficulties (taking into account systematic increases) and practical problems (processing for which national administrative systems were not geared) which it posed.

7. The Commission also had to authorize the Member States concerned – under Article 5(3)(b) of Regulation No. 2892/77 as amended – to apply a *correcting factor* to the data on zero-rated transactions obtained from returns. This proved necessary because those concerned were not filling in their returns with sufficient care since, for them, no direct financial consequences were involved.

8. *Under method B* a number of items which do not, strictly speaking, constitute VAT proceeds must first be deducted from total receipts. These are items such as fines, interest on late payments and collection costs where the latter are included in receipts. Belgium, France, Italy and the Netherlands have to make corrections in respect of fines, while France and Italy also do so in respect of collection costs.

9. The other corrections *apply equally to both methods*. These are intended to take account of:

- special geographic and administrative conditions and the reduction of certain VAT rates;
- flat-rate scheme for farmers;
- special schemes for smal firms;
- the options available under Annexes E and F of the Sixth Directive;
- the tax arrangements for motor vehicles and petroleum products.

10. The figure for total receipts has first to be corrected into more or into less to take account of various *specific national features*. For example:

- receipts in certain territories not covered by the Sixth Directive (Monaco, the Isle of Man, for example);
- reductions of VAT rate applicable to purchases from taxable persons in Berlin, the special rates for purchases and sales in the GDR, special reductions for certain transactions in Corsica;
- refunds to do-it-yourself housebuilders, to the BBC and ITN, to the Northern Ireland authorities and to local authorities in the United Kingdom.

11. The corrections applied in respect of special schemes for *small firms* in fact cover several possibilities. In the first place, under Article 8(1) of Regulation No. 2892/77 as amended, Member States applying a scheme of graduated tax relief for small firms in accordance with Article 24(2) of the Sixth Directive must add to total receipts the amount which would have been collected but for the scheme.

Four Member States (Germany, France, Luxembourg and the Netherlands) operate schemes of this kind and apply Article 8(1).

Only Luxembourg and the Netherlands are able to indicate the exact amount of tax relief granted; the other countries obtain their figures by extrapolation from previous data or by sample surveys.

12. However, the main correction that has to be carried out is where Article 2(3) of Regulation No. 2892/77 as amended is applied. This stipulates that transactions by taxable persons whose annual turnover does not exceed 10 000 ECU need not be taken into account for the purpose of determining VAT own resources. A Member State may, therefore, request negative compensation to take account of tax on turnovers below 10 000 ECU where the ceiling for exemption from VAT is less than that figure, while conversely it must make positive compensation where the ceiling is higher than 10 000 ECU.

13. Two of the Member States which could have claimed negative compensation, because their national ceilings are less than 10 000 ECU, have waived the right to do so (Ireland and Luxembourg). Germany, France and the Netherlands all apply graduated VAT relief schemes and have added the total amount of the tax reduction, making no distinction between small firms with a turnover of less than 10 000 ECU and those with a higher turnover.

This type of compensation is calculated by Belgium (which corrects its receipts), Denmark, Italy (which corrects its receipts in respect of small firms covered by the special flat-rate scheme existing until end 1982 and its intermediate tax base in respect of small firms subject to the normal arrangements) and the United Kingdom.

Ireland, the Netherlands and the United Kingdom make a positive compensation to take account of taxable transactions by businesses with a turnover of more than 10 000 ECU which are exempt. The calculation of this compensation still raises, however, specific problems.

14. To calculate these compensations information is needed on the value added by such firms and on how their sales are broken down between taxable persons and final consumers. This has posed numerous problems, most of which, however, have been solved. Generally speaking, no direct calculation can be made with the data available, and estimates have to be made on the basis of sample surveys or data for earlier years.

15. Under the optional flat-rate scheme, farmers are not allowed to deduct the VAT paid on their inputs nor to charge VAT on their sales. They do, however, receive flat-rate compensation, either from customers who are liable to tax or direct from the state, to offset the VAT charge on their inputs in part or in full. If the compensation is only partial, the Member State may (method B) deduct from receipts the full amount of tax not recouped (Article 8(2) of Regulation No. 2892/77 as amended). Under method A the value added of flat-rate farmers must be added to the base obtained from the returns (Article 5(3)).

16. Four Member States made corrections of this kind in 1983: Germany, France, Ireland and Italy. However, the calculation raises numerous problems. On one hand, the agricultural accounts for the year in question are not available. On the other hand, implementation of the Sixth Directive is sometimes incorrect and the very concept of the amount not recouped as well as over recouped are not sufficiently defined.

UNITED KINGDOM

Estimate of VAT own resources base

		million £		
	CRONOS	*1980*	*1981*	*1982*
– Final consumption of households on the economic territory	S1011000	136 850	151 720	166 280
– To be deducted (classification of the purposes of consumption)				
Gross rent (31)	Z7027100	20 770	24 742	27 120 *
Domestic services (46)	Z7037100	432	519	570 *
Services of physicians (53)	Z7043100	266	328	360 *
Hospital care (54)	Z7044100	273	346	380 *
Accident and health insurance services (55)	Z7045100	17	19	20 *
Communication (64)	Z7052100	2 002	2 480	2 720 *
Education (74)	Z7059100	2 760	3 128	3 430 *
Financial services, n.e.c. (85)	Z7067100	2 312	2 627	2 880 *
– Balance A		108 018	117 569	128 800
Intermediate consumption				
– General government	A6021200	20 836	22 831	26 561
– Private non-profit institutions	A7021200	:	:	:
– Branches exempt from VAT on production (NACE/CLIO classification R 44)[1]				
Communication (670)		1 260 *	1 390 *	1 530 *
Services of credit institutions (690=69A=69B)		1 920 *	2 110 *	2 320 *
Services of renting (730)		1 140 *	1 260 *	1 380 *
Services of education (750)		:	:	:
Market services of health (770)		:	:	:
Total B		25 156	27 591	31 791
Gross fixed capital formation				
– General government	A6021410	5 528	4 641	4 414
– Private non-profit institutions	A7021410	:	:	:
– Other branches exempt from VAT (NACE/CLIO classification R 25)	2			
Communication (67)	Z5026100	1 524	1 453	1 570 *
Credit institutions (69A)	Z5027100	3 973	4 688	5 070 *
Other market services (74)	Z5029100	9 539	9 005	9 730 *
Total C		20 564	19 787	20 784
Total base including VAT (A+B+C)	—	153 738	164 947	181 375
VAT to be deducted	A0112210	11 445	12 525	14 255
Total base excluding VAT	—	142 293	152 422	167 120

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1. Estimate by the Statistical Office on the basis of the 1975 input-output tables and an updating rate.
2. GFCF by branch of ownership
S = SEC 1 Z= ZCN2 A = AMP1.

* Statistical Office estimate.

For these reasons the Council had hoped, when it adopted Regulation No. 3652/83 amending Regulation No. 2892/77, that the Commission would propose an amendment to the paragraph in question. However, the Commission had decided to initiate the Article 169 procedure against Italy because of its failure to apply the rules in force, and therefore considered it untimely to make any such proposals while the procedure was still under way.

17. As regards the compensations in respect of the options offered under Annex E (transactions which may continue to be taxed although they should be exempt) and Annex F (transactions which may continue to be exempted although they should be taxed) the principle applied is to seek to arrive at the situation which would exist if the Sixth Directive was applied in full. In the case of Annex E, purchases corresponding to supplies to taxable persons have to be

RELATIVE IMPORTANCE OF CORRECTIONS

1983 VAT BASE (%)
(situation at 30.6.1984)

		Belgium	*Denmark*	*Germany*	*France*	*Italy*	*Luxembourg*	*Netherlands*	*United Kingdom*	*Ireland*[1]
I.1	Total receipts	100	100	100	100	100	100	100	100	100
I.2	Fines	- 0.0	—	—	- 0.2	- 0.0	—	- 1.5	—	—
I.3	Collection costs	—	—	—	+ 0.0	+ 0.0	—	—	—	—
I.4	Small businesses	- 0.3	- 0.2	—	—	- 0.2	—	—	[3]	—
I.5a	Other corrections (+)	—	+ 0.7	+ 2.7	+ 0.1	+ 0.4	—	—	+ 6.6	+25.3
I.5b	Other corrections (−)	- 2.0	- 2.0	—	-11.1	- 0.0	—	—	- 0.1	- 1.5
I.6	Graduated relief	—	—	+ 0.1	+ 0.2	—	+ 0.0	+ 0.3	—	
I.7	Flat rate farmers	—	—	- 0.2	- 0.4	+ 1.9	—	—	—	+13.7
	Total corrections	- 2.3	- 1.5	+ 2.6	-11.4	+ 2.1	+ 0.0	- 1.3	+ 6.5	+37.5
III.	Intermediate base	100	100	100	100	100	100	100	100	100
IV.1	Small businesses	—	—	—	—	- 1.1	—	+ 0.3	+ 0.0	+ 0.3
IV.2a	Annex E	- 0.2	- 0.5	- 0.4	- 0.0	- 0.6	—	—	- 0.2	—
IV.2b	Annex F	+ 1.2	+ 1.5	+ 1.5	+ 0.5	+ 1.2	+45.2	+ 1.5	+ 0.1	+ 0.9
IV.2c	Annex G	—	—	—	—	—	—	—	—	—
IV.3a1	Motor vehicles	[2]	- 0.2	—	- 1.1	- 0.0	—	—	- 0.7	- 0.8
IV.3a2	Petroleum products	[2]	- 0.3	—	- 3.6	—	—	—	—	- 1.3
IV.3b	Art. 17(7) Dir. 77/388	—	—	—	—	- 3.2	—	—	—	—
	Total compensations	+ 1.0	+ 0.6	+ 1.1	- 4.2	- 3.8	+45.2	+ 1.7	- 0.8	- 1.0

1. In 1983, Ireland was the only country using the returns method. The figures thus relate not to total receipts lent but to the intermediate taxable base.
2. Corrections made to receipts.
3. Corrections made to the base.

added and the value added corresponding to sales to final consumers has to be deducted; in the case of Annex F, the value added corresponding to sales to final consumers has to be added and purchases corresponding to supplies to taxable persons deducted. This means that data must be available on purchases and on the breakdown of sales between intermediate and final consumers.

In practice the data used for this calculation are extremely varied, ranging from figures taken direct from the national accounts to statistics produced by trade associations and ad hoc surveys. In short, each compensation has to be calculated using a specific methodology and the calculations, which involve a considerable amount of work, have been the subject of numerous discussions during control visits. The number of problems currently still unresolved is very limited.

18. Compensations also have to be calculated for restrictions on the right to deduct in respect of motor vehicles and petroleum products, which are authorized – again for a transitional period which has not yet ended – under the second subparagraph of Article 17(6) and Article 17(7) of the Sixth Directive, since Article 9(4) of Regulation No. 2892/77 as amended stipulates that the own resources base should be calculated as if the exercise of the right to deduct had not been restricted.

The calculation must cover only purchases of petroleum products and motor vehicles used for business purposes. The portion accounted for by private use therefore has to be excluded; this is something which has also posed a large number of problems and the Commission initiated the Article 169 infringement procedure against the United Kingdom in 1984.

Five Member States calculate a compensation in respect of restrictions on the right to deduct for motor vehicles (Belgium – which makes the correction to its receipts – Denmark, Ireland, France, Italy and the United Kingdom). The same Member States, except for the United Kingdom, also calculate a compensation for restrictions on the right to deduct in respect of petroleum products. These calculations are based either on input-output tables (France) or on data calculated by the national statistical offices from sales figures for vehicles and petroleum products and from tax statistics.

B. Weighted average rate

19. The calculation of the weighted average rate is the most important aspect of the revenue method (method B), both as regards the methodology used and in terms of the volume of work involved. Consequently the statements of the VAT own resources base presented by the Member States pursuant to Article 10 of Regulation No. 2892/77 as amended and the control reports prepared by the Commission and each of the Member States look into this matter in considerable detail. The ACOR has also frequently discussed various aspects of the calculation.

20. It is therefore almost impossible to summarize in only a few pages the various stages involved in practice and the problems that have been encountered since 1979. The following discussion will therefore be limited to a number of points relating to two particularly important aspects: the sources used and the way in which the final consumption of households is treated.

Regulation No. 2892/77 as amended states that the source used in the first instance must be the national accounts prepared in accordance with the European System of Integrated Economic Accounts (ESA) and then internal national accounts and lastly any other appropriate source.

Belgium, Italy and Luxembourg use the ESA national accounts to calculate the weighted average rate; in Germany, France, the Netherlands and the United Kingdom the internal national accounts are the main source used. In the case of France, however, these coincide very nearly with the ESA presentation.

21. Since the national accounts are not designed for the purposes of fiscal analysis, other sources have to be used in all these cases to determine the breakdown of transactions by VAT rate where the finest breakdown in the national accounts still includes transactions taxed at different rates. In France and Italy the situation in this respect is rather special.

France uses a system known as the "modèle TVA" ("VAT model"), predating Regulation No. 2892/77, under which a link is established between receipts and the national accounts. Italy, on the other hand, makes much greater use than other Member States of sources other than the national accounts and, in particular, of statistics based on the VAT returns of taxable persons and the findings of household spending surveys. However, all the Member States find themselves obliged to use some additional sources.

22. The breakdown of household consumption by rates has been chosen as an example because in all the Member States expenditure on household consumption constitutes by far the most important element of the taxable base, in other words of the weightings which determine the weigh-

ted average rate. It is also a category of expenditure on which the national accounts contain relatively detailed information; the table "Final consumption of households on the economic territory" (P3B) under the ESA provides a breakdown by some 40 items. However, in some cases these items have to be broken down using other sources, notably statistics based on VAT returns (Germany, France and Italy) and household expenditure surveys (Belgium and Italy).

Although the use of these statistics to provide an objective basis for a breakdown by rate is not in general called into question, it does present certain difficulties because of the need to compare like with like. For example, when certain business classifications drawn from tax statistics are used for the breakdown, there is a danger that they may not allow a breakdown of all the transactions included under the item in the national accounts owing to the wide range of firms which sell certain products. Similarly it is hardly satisfactory that an item in the national accounts should be broken down by rate on the basis of a sales volume that is very much lower or higher than the item itself. In order that the same transactions may be deemed to have been covered the figures must be of much the same order of magnitude.

The same problems of correspondence between different classifications arise where household expenditure surveys are used as an additional source of information. Information is sometimes provided by trade associations (France).

In other cases the breakdown may be on the basis of reasonable approximations or it may be traditional. This applies to the United Kingdom, for example, where an effort has been made every year to reconcile VAT receipts with the national accounts – even before VAT own resources began to be calculated – although the exercise is less developed than in France. The traditional percentages are obtained from the statistics on the receipts from the turnover tax which existed in the United Kingdom before the introduction of VAT. In some cases these breakdowns are completely arbitrary. As they are of only minor significance, they do not appreciably affect the weighted average rate, but they are discussed during control visits and sometimes negotiations may take place where percentage breakdowns have been made with no factual basis whatever.

23. *In Belgium* the breakdown of consumer expenditure by rate is based on the ESA table of the consumption of households on the economic territory. The additional source used for the breakdown of certain items is the household budget survey dating from 1978-79, which – although somewhat dated now – is accepted in the absence of any suitable alternative.

The difficulties inherent in applying the results of the household budget survey are illustrated by the breakdown of the sub-item covering articles for personal care (which includes things such as toothpaste, hairlotion, and deodorants but not the associated appliances such as razors, toothbrushes and combs). Originally the breakdown was based on the survey headings covering "toothpaste, shaving cream and perfume", leaving out of account the items "other personal items for men" and "other personal items for women and children". When this error, only minor in itself, was corrected, it was found that the first decimal place of the weighted average rate was affected.

24. *In Germany* the breakdown of private consumption between the two rates is relatively simple. However, the method is slightly different from that used in the other countries in that exempt expenditure and expenditure at the lower rate are deducted from the total figure for private consumption, the remainder being total expenditure at the standard rate. This approach is obviously correct in principle, but it has made control more difficult, since a breakdown by rate for each item of private consumption makes it easier to discover any anomalies. International air travel, for example, is included under the ESA in the consumption of households on the economic territory provided that the tickets are purchased in the country in question. Although technically speaking they are not exempt, they are considered such for the purposes of calculating VAT own resources. This was not done when the weighted average rate was first calculated in Germany and the officials carrying out the control would have discovered the error more easily if there had been a breakdown of the individual items of private consumption.

Cases of an arbitrary breakdown are rare: 50% of the turnover of taxis (drawn from tax statistics) and 30% of lawyers' services (until 1982) were deemed to fall within private consumption. In calculating the weighted average rate, consumption on the farm and direct sales by flat-rate farmers are weighted by means of the average rate applicable to inputs, expressed as a percentage of outputs.

25. *In France*, too, the breakdown of private consumption (as it appears in the Final Uses section of the input-output tables) does not pose any major problems. The Estimates and Forecasts department (Direction de la Prévision) makes a breakdown by rate of the 90 branches in the input-output tables prepared by INSEE, which do not include VAT. The model calculates the amounts of non-deductible VAT, which are then incorporated by INSEE in the published input-output tables, which include VAT (40 branches).

Fiscal analysis is simplified by the fact that only three rates exist; INSEE is also able to call on data concerning uses and resources in respect of 600 products, which are used for making further breakdowns. The fact that these data make no distinction between intermediate and final uses is not always significant. In a breakdown between the upper and the intermediate rate it frequently turns out that goods taxed at the upper rate form part of private consumption by their very nature (e.g. breakdown of photographic equipment).

In exceptional cases use is made of statistics concerning VAT returns or statistics supplied by trade associations.

26. *In Italy* considerable use is made of the findings of the regular survey on household spending, which takes the place of ESA for a part of private consumption. The six sub-items of the ESA group "Furniture, furnishings, and household equipment and operation" are not included in the Italian calculation but are replaced by equivalent, though more detailed items from the household spending survey.

The same applies for a large part of the groups "Recreation, entertainment, education and cultural services" and "Miscellaneous goods and services". An example of the difficulties posed by the use of two different classifications is the major heading of the household spending survey which covers "Children's pocket money", to which no specific VAT rate can be assigned. It is therefore divided proportionally between the survey headings which replace the two ESA categories of private consumption referred to.

The complexity of the legislation requires a large number of additional breakdowns for which statistics based on VAT returns are used.

27. *In the Netherlands* the weighted average rate is calculated by the CBS on the basis of the data used for the detailed table of private consumption by purpose published in the national accounts (Nationale Rekeningen). Although there were some shortcomings at first owing to the lack of coordination between the CBS, whose knowledge of VAT legislation was inadequate, and the Ministry, these initial problems have been overcome.

From the control point of view the situation is less satisfactory, since the CBS refuses to provide anything other than qualitative information: officials carrying out controls have been given lists of the transactions taxed at the lower and the upper rates, but have received only little quantitative information concerning the calculations. This is because the CBS is required by law to make publicly known all information revealed to any person not employed by the CBS.

There are two small categories of transactions which are taxed but which are not included in the Netherlands private consumption statistics: gold transactions and transactions in antiques other than imports. These items are added separately to the calculation and are not based on CBS data.

28. *In the United Kingdom* the situation is more straightforward since there are only two VAT rates, including a zero rate used on a significant scale. Figures on consumer spending are available quarterly and are presented in greater detail than in the annual blue book. For example, all the items relating to food which are taxed at the standard rate rather than at the zero rate can be found direct in the listings giving the quarterly data.

As noted earlier, traditional percentages are used in some cases; these are sometimes backed up by data from other sources. The breakdown between clothing for adults (85%) and clothing for children (15%) is supported by the findings of the household spending survey; the half-and-half breakdown between residential caravans and holiday caravans tallies by and large with the findings of a survey published in Business Monitor.

A special calculation is carried out for international rail travel: where the ticket is purchased abroad, the part of the journey travelled within the United Kingdom is added, since it is not included under the consumption of households on the economic territory. The same applies to certain premiums for housing maintenance. The net figures appear under consumer spending in the blue book, but the amount of the premiums is added for the purpose of calculating the weighted average rate.

PART TWO

PROPOSAL FOR A COUNCIL REGULATION (ECSC, EEC, EURATOM) No. ...

extending the term of validity of Regulation No. 2892/77 implementing, in respect of own resources acruing from value added tax, the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources, as last amended by Council Regulation (EEC, Euratom, ECSC) No. 3625/83 of 19 December 1983

EXPLANATORY MEMORANDUM

Council Regulation (EEC, Euratom, ECSC) No. 2892/77 of 19 December 1977 implementing, in respect of own resources accruing from value added tax, the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources was originally intended to apply for a transitional period of five years ending on 31 December 1982.

Because of delays in implementing the common system of value added tax, and hence VAT own resources, in December 1982 the Council adopted Regulation (EEC, Euratom, ECSC) No. 3550/82 extending the transitional period to 31 December 1985; in December 1983 it then adopted Regulation No. 3625/83, which made a number of amendments to Regulation No. 2892/77 itself. One of these amendments was that the Commission should present a report on implementation of the amended Regulation by the end of 1984.

This report is included with the present proposal to extend the term of validity of the amended Regulation No. 2892/77 and contains a detailed analysis of the current situation as regards implementation. The conclusions may be summed up as follows:

The Commission considers that it is still too early at this stage to propose a definitive method for establishing the VAT own resources base – for three main reasons:

(i) The amended Regulation No. 2892/77 will be applied for the first time to the calculation of the 1983 VAT base, for which the statements were sent to the Commission on 30 June 1984; the controls are still in progress in several Member States. The Commission therefore has only very limited experience of implementation of the new version of this Regulation.

(ii) The regulations and other legal instruments governing the calculation of the VAT own resources base on which Regulation No. 2892/77 is based are themselves being amended. This is the case with the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources (Commission proposal for a new decision on the Community system of own resources sent on 21 July 1984), Regulation No. 2891/77 implementing the Decision of 21 April 1970 (revision in progress on the basis of proposals presented by the Commission since July 1982), the Financial Regulation applicable to the general budget of the Communities and the Sixth VAT Directive, on which harmonization work is continuing and has still to be completed. Furthermore, one Member State has still not started to pay VAT own resources and, from 1986, two new Member States should also start to participate in the Community own resources system.

(iii) Eight Member States paying VAT own resources have now chosen to calculate the VAT base by the revenue method (method B); the method which the Commission and Parliament wished to have used – the returns method (method A) – is now only used by one of them. This state of affairs considerably changes the conditions in which the Commission is called upon to propose a definitive method for calculating the base.

The results of the first years' application of Regulation No. 2892/77 show that, despite difficulties of implementation which should not be minimized but which for the most part have been solved, this Regulation has enabled the Community to receive the VAT own resources due to it. The current system can and must be perfected. However, in its current state, it achieves its objective of making possible the establishment of a harmonized base for the collection of VAT resources.

The Commission therefore proposes that the end of the transitional period now scheduled for 31 December 1985 should once again be deferred by three years.

PROPOSAL FOR A COUNCIL REGULATION (ECSC, EEC, EURATOM) EXTENDING THE TERM OF VALIDITY OF REGULATION (EEC, EURATOM, ECSC) NO. 2892/77

implementing, in respect of own resources accruing from value added tax, the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 209 thereof,

Having regard to the Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources,[1] and in particular Article 6(2) thereof,

Having regard to the proposal from the Commission,[2]

Having regard to the opinion of the European Parliament,[3]

Having regard to the opinion of the Court of Auditors,[4]

Whereas under Article 14 of Regulation (EEC, Euratom, ECSC) No. 2892/77[5] as last amended by Regulation (EEC, Euratom, ECSC) No. 3625/83,[6] that Regulation shall apply from 1 January 1983 for a transitional period expiring on 31 December 1985;

Whereas Regulation No. 3625/83 was first applied to the preparation of the statement indicating the total definitive amount of the VAT base for 1983;

Whereas under Article 10(1) of Regulation No. 2892/77, this statement was not sent by the Member States until 1 July 1984; that the experience of several financial years is necessary before a definitive uniform system can be produced for collecting own resources from value added tax;

Whereas the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment[7] – has still not been completely harmonized; whereas, in particular, Annexes E and F still remain;

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[1] OJ No. L 94, 28.4.1970, p. 19.

[2] . . . .

[3] . . . .

[4] . . . .

[5] OJ No. L 336, 27.12.1977, p. 8.

[6] OJ No. L 360, 23.12.1983, p. 1.

[7] OJ No. L 145, 13.06,1977, p. 1.

Whereas, in order to continue collection of own resources and prepare the definitive system, this transitional period should be extended to 31 December 1988 and the provisions of Regulation (EEC, Euratom, ECSC) No. 2892/77 should remain in force for the time being;

HAS ADOPTED THIS REGULATION:

Article 1

Article 14 of Regulation (EEC, Euratom, ECSC) No. 2892/77 shall be amended as follows:

(a) in the second subparagraph, "1985" shall be replaced by "1988";
(b) in the third subparagraph, "1984" shall be replaced by "1987";
(c) in the fourth paragraph, "1985" shall be replaced by "1988".

Article 2

This Regulation shall enter into force on the day following its publication in the Official Journal of the European Communities.

It shall apply from 1 January 1986.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Council
The President

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 51-52 of the January 1985 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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(B. 56.596)

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doing business in Asia and the Pacific.
International Business Series. Volume 3. Edited by Prof. Dennis Campbell.
Deventer, Kluwer, 1985. 437 pp., 275 Dfl.
Introduction to a selected number of countries in Asia and the Pacific with respect to investment climate and doing business, including reference to taxation. Supplements will update the material.
The countries included are: Australia, China (People's Rep.), India, Indonesia, Japan, Korea (Rep.), Malaysia, Nepal, New Zealand, the Philippines, Singapore, Taiwan, Thailand.
(B. 56.589)

ASEAN

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Eugen Jehle:

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M.H. Collins:

Politik und Praxis in Grossbritannien in der steuerlichen Behandlung von Verrechnungspreisen 354
Der Verfasser bespricht u.a. die folgenden Themenkreise: das britische Gesetz zu den Verrechnungspreisen, die Auswirkungen von Doppelbesteuerungsabkommen, die britischen Steuerbehörden und ihre Verwaltungspraxis, Erfordernisse bei der Beschaffung von Informationen, Informationsquellen, die Vertraulichkeit erhaltener Informationen, die Vorgehensweise der Steuerbehörde bei Nachforschungen, Häufigkeit der Anfragen von Steuerbehörden, die gemeinsame Konsultation mit anderen Steuerbehörden, und die Behandlung von Gewinnen von Betriebstätten.

M. Symons:

Grossbritannien: Die Funktion des "Senior Management System" in der britischen Steuerverwaltung 363
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Grossbritannien: Gesellschaften mit Doppelsitz – Möglichkeiten und Missbräuche 373
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Nathan Boidman:

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Helmut Debatin:

Die Rolle der Doppelbesteuerungsabkommen als Instrument Wirtschaftlicher Zusammenarbeit zwischen "kapitalistischen" und "sozialistischen" Ländern *393*
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M.B. Rao:

Wichtige Aspekte zu Vereinbarungen über Zusammenarbeit *400*
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Eugen Jehle:

Die Besteuerung in der Volksrepublik China
– Steuergesetze – Steuerliche Förderungsmassnahmen
– Doppelbesteuerungsabkommen –
– Eine kurze Einführung – *405*
Der Verfasser stellt zunächst die derzeit relevanten Steuergesetze der Volksrepublik China vor. Danach beschreibt er die steuerlichen Vergünstigungen, die insbesondere in den Sonderwirtschaftszonen, in den Wirtschaftsentwicklungszonen und in den damit verbundenen "offenen Städten" gewährt werden. Schliesslich werden die Doppelbesteuerungsabkommen, die die Volksrepublik China bislang abgeschlossen hat, kurz analysiert.

Nathan Boidman:

Canada: Affaires concernant les dispositions de crédit d'impôt fictif dans les conventions fiscales *387*
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Helmut Debatin:

Le rôle des conventions fiscales comme instrument de coopération économique entre les pays "capitalistes" et "socialistes" *393*
L'auteur commente la modification des relations contenues dans les conventions fiscales entre les pays de l'Europe de l'Est et ceux traditionnellement mentionnés à l'Ouest. Il conclut que les pays socialistes en insistant et en démontrant l'idée de réciprocité ont largement contribué à une compréhension plus ouverte des politiques conventionnelles internationales.

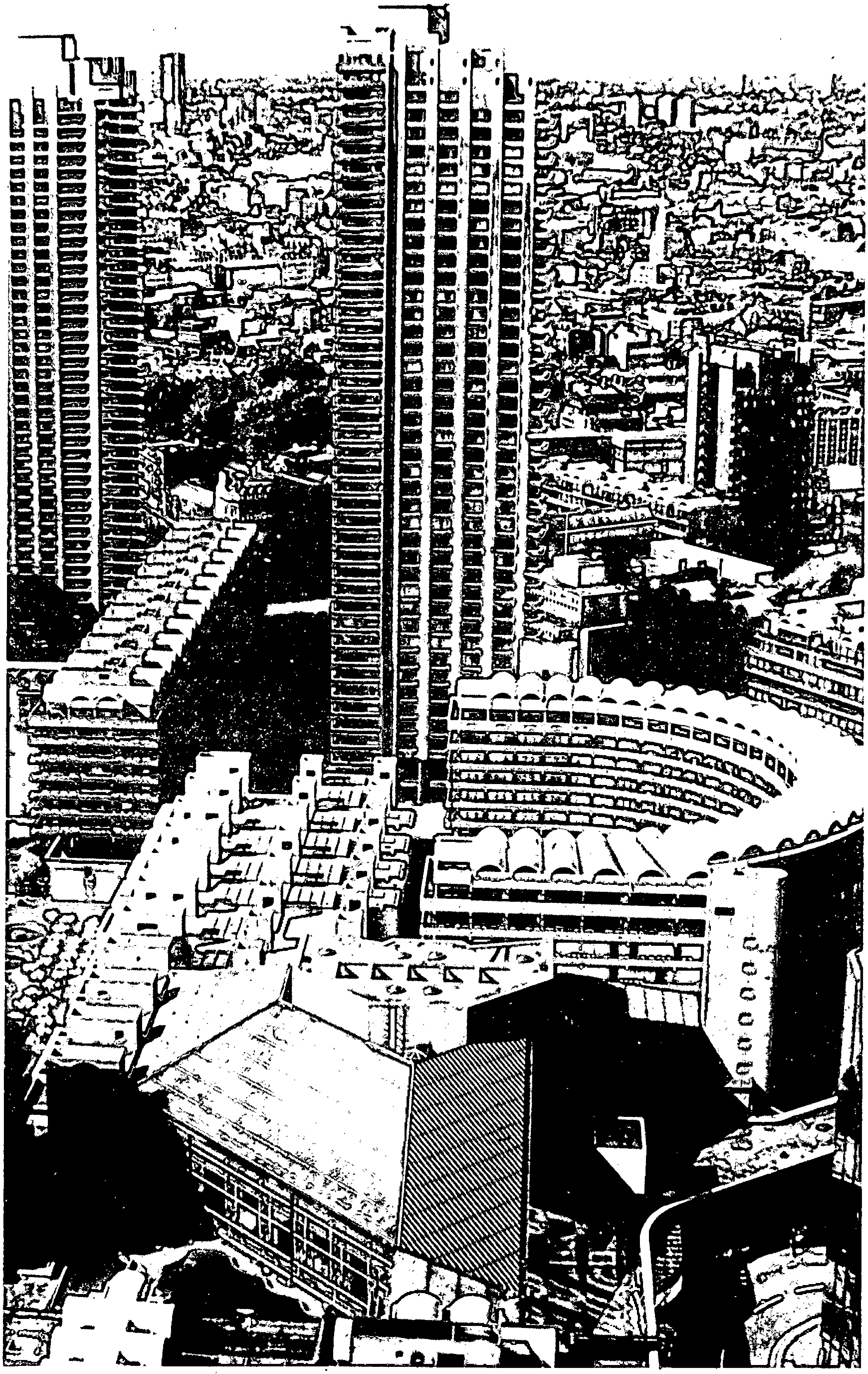
M.B. Rao:

Accords de collaboration: quelques informations *400*
L'auteur commente les nombreux problèmes liés aux accords de collaboration conclus entre les entreprises des pays développés et des pays en voie de développement, ainsi que les conséquences fiscales de tels accords. Il critique par ailleurs les Etats-Unis qui refusent d'introduire les clauses de crédit d'impôt fictif dans leurs conventions fiscales.

Eugen Jehle:

Imposition en République Populaire de Chine *405*
– Lois fiscales – Avantages fiscaux – Conventions fiscales –
– Brève introduction –
L'auteur décrit tout d'abord les lois fiscales couramment appliquées en République Populaire de Chine, puis analyse les avantages fiscaux particulièrement appliqués dans les Zones Economiques Spéciales, les Zones de Développement Economique et les Agglomérations de "Vieilles Villes". L'auteur termine par une rapide analyse des conventions fiscales signées par la Chine.

IFA Congress 1985 – London



The Barbican Congress Centre – London

Subjects	Sujets	Themen	Temas
Subject I The assessment and collection of tax from non-residents	**Sujet I** L'établissement et la perception des impôts à charge des non-résidents	**Thema I** Die Steuerveranlagung und -Erhebung bei Nicht-Ansässigen	**Tema I** La determinación y percepción de impuestos de los no residentes
Subject II International double taxation of inheritances and gifts	**Sujet II** La double imposition internationale des successions et donations	**Thema II** Internationale Doppelbesteuerung bei Erbschaften und Schenkungen	**Tema II** La doble imposición internacional sobre las herencias y donaciones
Seminar A International tax problems of charities and other private institutions with similar tax treatment	**Séminaire A** Problèmes fiscaux internationaux des organismes sans but lucratif et institutions assimilées	**Seminar A** Internationale Steuerprobleme bei Stiftungen und anderen, steuerlich ähnlich gestellten privaten Institutionen	**Seminario A** Problemas fiscales internacionales de las instituciones privadas de beneficiencia y de otras con tratamiento similar
Seminar B Interpretation of tax treaties – conflicts caused by reference to internal law	**Séminaire B** Interprétation des conventions fiscales – conflits créés par référence à la loi interne des Etats	**Seminar B** Auslegung von Doppelbesteuerungsabkommen – Konflikte durch Verweisung auf internes Recht	**Seminario B** Interpretación de tratados en materia fiscal – conflictos creados por su referencia a las leyes internas de los Estados
Seminar C Tax aspects of new types of financing transactions	**Séminaire C** Aspects fiscaux des nouvelles techniques financières	**Seminar C** Steuerliche Aspekte neuartiger Finanztransaktionen	**Seminario C** Aspectos fiscales de las nuevas clases de transacciones financieras

Congrès Londres 1985

MAX LAXAN
Président de l'IFA

Après l'Amérique du Sud et le chaleureux accueil de Buenos-Aires, notre rassemblement annuel va retrouver l'Europe. Pour la troisième fois, il sera l'hôte de la Cité de Londres. Le 39ème Congrès de l'IFA se tiendra au Centre Barbican pour les Arts et les Conférences, dont les installations sont en mesure de recevoir, dans les meilleures conditions, tous les participants – et ils seront sans doute plus nombreux que jamais – qui se rendront à l'invitation du Groupement britannique.

C'est la dernière fois, cette année, que j'ai l'honneur de m'adresser aux lecteurs du Bulletin pour leur présenter les thèmes qui seront soumis à leur examen. La charge de Président de l'IFA, qui m'a été confiée il y a quatre ans à Berlin, viendra en effet à son terme à la fin du Congrès de Londres. Je tiens à remercier ici les participants à nos réunions, qui, par leur fidélité, leur assiduité et leur contribution à nos travaux ont permis que l'Association exprime aux autorités fiscales des différents pays des avis mesurés et réfléchis sur les questions, très importantes pour l'avenir des relations internationales, qu'elle avait mises à l'ordre du jour de ses assemblées.

Le premier sujet inscrit au programme de notre Congrès concerne l'établissement et la perception des impôts à la charge des personnes non-résidentes. C'est un champ d'études particulièrement vaste dans la mesure où il recouvre les différentes catégories d'impôts de caractère personnel que peuvent comporter les législations nationales, qu'il s'agisse de taxer les revenus, les plus-values ou encore les biens en capital, mobiliers et immobiliers. Toutefois, les investigations ne devaient pas porter sur la matière imposable elle-même et les conditions de son assujettissement à l'impôt mais, cette matière et ces conditions étant ce qu'elles sont, sur les modalités d'établissement et le recouvrement des contributions et taxes mises à la charge de non-résidents, dans la mesure notamment où ces modalités diffèrent de celles mises en oeuvre en ce qui concerne les contribuables résidents.

En fait, le remarquable travail accompli par les deux rapporteurs généraux, J.S. Phillips et M.H. Collins, sur la base des éléments fournis par les vingt-sept rapporteurs nationaux et des réponses aux questionnaires très complets qu'ils ont été invités à remplir, déborde largement le propos initial. Il nous donne de précieuses indications sur le contenu, dans les diverses législations, de la notion de résident, sur la capacité fiscale des non-résidents et spécialement sur l'application de la théorie de la source, en ce qui concerne plus particulièrement le bénéfice dérivant – ou supposé dériver – d'une activité commerciale, d'une profession libérale ou d'un investissement en valeurs mobilières. Certes, nombre de ces problèmes ont déjà été traités dans nos assemblées, notamment à Montréal en 1982 pour ce qui est du régime fiscal des intérêts des prêts ou des services rendus par des prestataires indépendants. Mais le champ d'application de l'impôt à des non-résidents n'avait jamais été cerné d'une manière aussi complète et, pour tout dire, exhaustive.

Le non-résident n'est soumis, par définition, qu'à une obligation fiscale limitée, liée à la seule activité exercée ou aux seuls biens possédés dans le pays concerné. En principe l'impôt est établi, liquidé et recouvré comme pour le résident, aux différences près qui résultent du refus de prendre en compte les éléments de la situation personnelle du contribuable ou encore certaines dépenses exposées en dehors de la juridiction fiscale. Dans de nombreux cas cependant, l'imposition de non-résident est établie sur une base forfaitaire, appliquée aux recettes brutes, négligeant les dépenses exposées en contrepartie. Un tel prélèvement s'applique aussi bien aux revenus des capitaux mobiliers qu'à l'exercice d'une activité professionnelle occasionnelle. Opérée par voie de retenue à la source, l'imposition forfaitaire, d'un montant souvent élevé, satisfait davantage les intérêts de l'Etat de la source que l'équité fiscale. Le développement d'un réseau de conventions internationales, à partir des modèles proposés notamment par l'OCDE, a porté heureusement remède aux anomalies les plus flagrantes et c'est dans ce cadre que des progrès peuvent encore être accomplis.

Il ne semble pas, en définitive, qu'à proprement parler, l'établissement ou la perception de l'impôt à la charge des non-résidents soulève des difficultés importantes ou générales, tant du côté de la juridiction fiscale que des contribuables eux-mêmes, si l'on veut bien mettre entre parenthèses l'inévitable lenteur des procédures administratives mises en oeuvre notamment dans le cadre des conventions bilatérales relatives aux doubles impositions.

Vingt quatre rapports nationaux, établis sur la base d'un questionnaire très élaboré, ont permis à W.D. Goodman de présenter un rapport général particulièrement documenté et complet sur les différents types de cas de double imposition en matière de succession ou de donation et sur les mesures prises en vue d'y porter remède. L'Association, dans son Congrès de Montevideo en 1968, avait déjà abordé le problème de la compétence des autorités fiscales dans ce domaine, mais à une époque où le principe de la territorialité était suffisamment admis pour service de base au règlement des conflits de compétence. Depuis cette date, et sans que cette notion soit abandonnée, le critère du domicile s'est affirmé comme le principe central déterminant le droit à imposition sur l'ensemble des actifs net mondiaux laissés par le défunt. Seul ce principe permet en effet, comme en matière d'impôt sur le revenu, l'application correcte de la personnalisation de l'impôt et spécialement de la progressivité des barèmes en fonction de l'importance de la succession. Dès lors la multiplication des conflits de compétence et des doubles impositions qui en résultent a entraîné, notamment entre pays développés, l'établissement d'un réseau de conventions prévoyant l'imputation sur l'impôt de l'Etat du domicile de tout ou partie des prélèvements effectués par l'Etat du situs ou de la source. L'extension de ces traités a été grandement facilitée par les travaux très détaillés conduits par le Comité des affaires fiscales de l'OCDE et qui ont trouvé leur aboutissement dans le modèle de convention de double imposition sur les successions de 1966, remanié et étendu aux donations en 1982. Rarement un tel effort de clarification doctrinale et de coopération aura produit autant d'effet dans le domaine des relations fiscales internationales, de sorte qu'à l'heure actuelle, si tous les problèmes de cumul d'impositions ne sont pas réglés, les voies ont été dégagées pour parvenir à des solutions conformes aux intérêts des Etats comme à ceux des contribuables.

Aussi bien le rapport de W.D. Goodman ne comporte-t-il pas de recommendations particulières et laisse-t-il aux travaux du Congrès le soin d'y pourvoir, s'il y a lieu. Son très grand mérite consiste à analyser, d'une manière ordonnée et claire, les différents critères d'imposition, les nuances, voire les différences, qu'ils peuvent comporter dans les diverses législations nationales et les moyens dégagés pour résoudre les difficultés correspondantes, par exemple celles tenant à une double revendication de l'imposition globale en fonction du domicile. Tous les cas possibles de cumul d'impositions résultant de l'application respective des principes de territorialité, de résidence ou de nationalité sont passés en revue, ainsi que les solutions qui leur sont apportées de manière unilatérale ou conventionnelle.

Ce travail considérable accompli par le Rapporteur Général fournira aux praticiens comme aux chercheurs une documentation de premier ordre et les éléments d'une réflexion approfondie.

Le programme de notre Congrès sera complété, cette année encore, par trois séminaires qui, grâce à la fixation au dimanche de la cérémonie d'ouverture, se tiendront successivement, les mardi, mercredi et vendredi. Ils apporteront des éléments d'information et de discussion sur des points particuliers de la législation fiscale. Le séminaire A traitera des organismes sans but lucratif et de l'extension des avantages dont ils bénéficient à leurs placements extérieurs. Le séminaire B examinera les problèmes que pose l'interprétation des conventions fiscales à la lumière des dispositions de la loi interne des pays concernés. Enfin, l'imagination des opérateurs sur les différentes places financières ayant permis de créer une grande variété d'instruments nouveaux dont les modalités d'imposition ne sont pas sans poser quelques difficultés, le séminaire C apportera une contribution fort utile dans un domaine sans doute très particulier de la fiscalité, mais dont l'évolution rapide des techniques souligne l'actualité.

Voilà donc, sommairement évoqué, le très substantiel programme scientifique proposé à nos réflexions et à nos discussions. Il s'y ajoutera la satisfaction de pouvoir entretenir et développer les relations personnelles et amicales qui font le charme de nos réunions. A tous, je souhaite un excellent Congrès.

London Congress 1985

After South America and the warm reception in Buenos Aires, our annual meeting will once again have a European setting. For the third time, it will be held in London. This 39th IFA Congress will take place at the Barbican Centre for the Arts and Conferences which, with its excellent facilities, will be able to comfortably accommodate all the participants – undoubtedly more numerous than ever – responding to the invitation of the London branch of IFA.

This year is the last time I have the honor to address the readers of the Bulletin and to introduce the subjects put forth for discussion at the Congress. My term as President of IFA, conferred on me four years ago in Berlin, will expire at the end of the London Congress. I should like to thank the participants of our past meetings who, through their loyalty, their assiduousness and their contribution to our work, made it possible for the Association to express to the fiscal authorities of the various countries its balanced and considered opinion on the questions – so important to the future of international relations – which were put forward on past conference agendas.

The first subject on this year's Congress agenda concerns the assessment and collection of taxes on non-residents. This is a particularly vast field in that it covers all the different categories of taxes of a personal nature which may be levied by national legislation, be they on income, capital gains, or real and personal property. However, our inquiry is not concerned with the taxable subject itself nor with the conditions under which it is subjected to tax but rather, taxable subject and conditions aside, with the methods of assessment and collection of taxes levied on non-residents, notably where such methods differ from those put into practice regarding residents.

In fact, the remarkable work accomplished by the two general rapporteurs, J.S. Phillips and M.H. Collins, based on information furnished by the twenty-seven national rapporteurs and the in-depth responses to the questionnaires they were requested to complete, goes far beyond the original proposal. It gives us a priceless indication of the components, in the various legislations, including the definition of resident, the taxability of non-residents and, especially, the application of the principle of taxation in the source-country, particularly as it relates to profits derived from – or deemed to derive from – a commercial activity, a profession (attorney, doctor, accountant, etc.) or investments in stocks and securities. Of course, a number of these issues have already been dealt with in previous IFA Congresses, notably in Montreal in 1982, as they relate to the tax treatment of interest on loans or income from independent personal services. However, the taxation of non-residents has never been approached in such a thorough – one might even say – exhaustive manner.

The non-resident, by definition, is only subjected to a limited tax obligation, related solely to the activity exercised or the property owned in the country concerned. In principle tax is determined, assessed and collected in the same way as for the resident, the only difference being the unwillingness to take into account the personal situation of the taxpayer or certain expenses which fall outside the jurisdiction of the tax system. In many cases however, taxes on non-residents are established on a fixed rate basis, applied to gross receipts with no setting off of expenses. Such levy is applied to the income from shares and securities as well as to the intermittent exercise of a professional activity. Operating through withholding at source, the fixed rate tax, often at a high rate, frequently serves more the interests of the State than fiscal equity. The development of a network of international treaties, beginning with the OECD Model treaty, has, happily, remedied some of the more flagrant anomalies. It is within the OECD Model framework that further progress can be accomplished.

Finally, it does not appear that the establishment or collection of taxes levied on non-residents raises considerable or general difficulties on the side of the tax authorities or on that of the taxpayers themselves, let aside the inevitable slowness of the administrative procedures practiced, notably in the bilateral treaties on double taxation.

The twenty-four national reports, established on the basis of an extensive questionnaire, have made it possible for W.D. Goodman to present a particularly well documented and complete general report on the various kinds of double taxation on inheritances and gifts and on the measures taken to remedy the situation. The Association, at the Montevideo Congress in 1968, discussed the jurisdictional problems of the tax authorities in this domain but that was in an era when the principle of territoriality was considered the basis for solving any jurisdictional conflicts. Since that time and without abandoning that principle, domicile has become the central criterion determining the right to tax the net assets, world-wide, of the deceased.

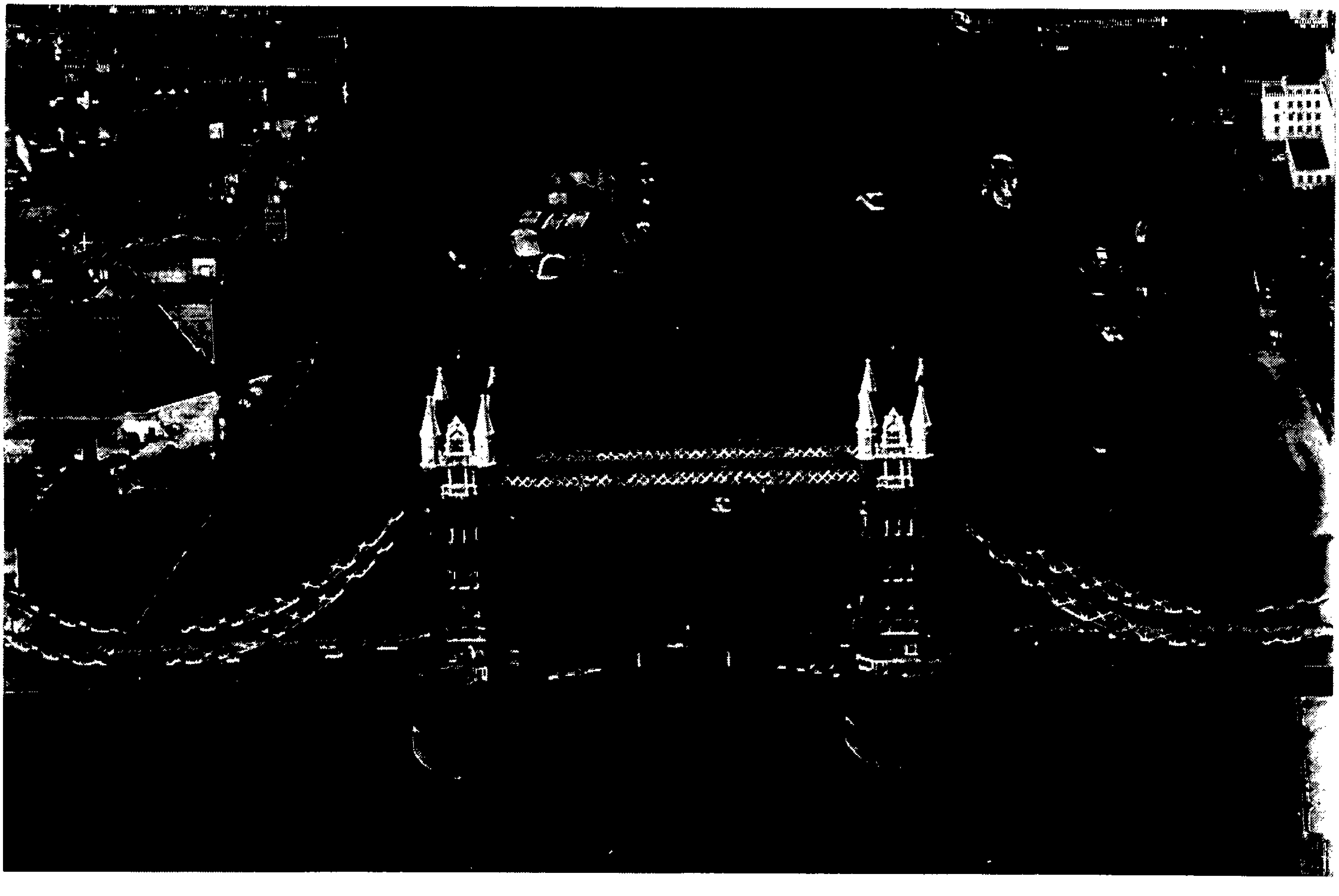
It is only on the basis of this principle that one can, in effect, as it is done for the income tax, correctly personalize the tax and, in particular, determine the progressivity of rates in relation to the size of the inheritance. Since 1968, the increase in jurisdictional conflicts and in double taxation has led, notably between developed countries, to the establishment of a treaty network taking into account the imputation by the domiciliary State of all or part of the tax imposed by the situs, or source, State. The extension of such treaties has been greatly facilitated by the detailed work of the OECD Committee on Fiscal Affairs which resulted in the OECD model double taxation treaty on inheritances in 1966, revised and extended to include gifts in 1982. Rarely has such an effort of clarification and cooperation produced such immense effects in the field of international fiscal relations, so that at this moment, even if all the cumulative problems of taxation are not yet resolved, the path is now clear to find solutions conforming to the interests of the State as well as to those of the taxpayer.

By the same token, Mr. Goodman's report does not offer any precise solutions but rather leaves that to the IFA Congress, should the occasion arise. The principal merit of the report consists in analysing, in a clear and concise manner, the different criteria utilized in levying tax, the various nuances, i.e. differences, that are found in national legislations and the means taken to resolve the corresponding difficulties; for example, a situation resulting in a double imposition as a a result of a worldwide taxation based on domicile. All possible cases of cumulative taxes resulting from the respective principles of territoriality, residence or nationality are addressed in the report as well as the corresponding remedies, whether unilateral or by treaty.

The major work accomplished by the General Rapporteur will provide practitioners as well as researchers with a document of the highest quality and will no doubt be the source of in-depth reflexion.

The Congress program will be completed again this year by three seminars which, due to the opening ceremonies taking place on Sunday, will be held successively on Tuesday, Wednesday and Friday. These will be the basis for information and discussion on particular points of tax legislation. Seminar A will consider non-profit organizations and the extension of privileges from which they benefit with regard to their foreign investments. Seminar B will examine problems in interpretation of tax treaties in the light of the domestic law of the country concerned. Finally, the imagination of finance operators in the various money markets having created a large variety of new instruments the taxation of which is not without leading to some difficulties, Seminar C, on the tax aspects of new types of financing transactions, will make a useful contribution to a field, indeed a rather sophisticated one, in which the rapid development of techniques underlines the present interest.

Such is, briefly summarized, the substantial scientific program set forth for our consideration and discussion. Added to it will be satisfaction derived from maintaining and developing the friendly personal relations which are a distinctive feature of our reunions. To one and all, I wish an excellent Congress.



Tax Reform in the United Kingdom

By the Rt. Hon. Nigel Lawson, M.P., Chancellor of the Exchequer

1. My predecessor as Chancellor of the Exchequer, Geoffrey Howe, writing in *European Taxation* in 1982 about the first three years of Margaret Thatcher's Government finished with these words:

> . . . I think it is fair to say that over the past few years the British tax system has been transformed for the better. . . . . I am sure that, in the future, tax reform will be seen to have been a critical step on the road to economic recovery.

2. The truth of those words becomes daily more apparent. The evidence is to be seen in the increasing strength of the British economy, with inflation remaining low, national output at its highest ever level, and our longest period of uninterrupted growth since the 1973 oil price explosion.

3. It is also to be seen in the gradual emergence of a more vigorous and dynamic economy, where competition and enterprise can flourish and in which business can expand, make profits and create new jobs.

4. And, last but not least, it is to be seen in the growing recognition of the value of a sensible taxation strategy in helping to bring about and reinforce this necessary process of economic change.

5. So I welcome this chance to describe what we have done in the tax field since 1982, to explain the reasons which lay behind the major tax reforms in my first two Budgets and to look forward to the further opportunities for extending the programme of tax reform on which I have embarked.

6. First, though, it is instructive to look back to the tax system which the incoming Conservative Government inherited from Labour in 1979 and to the changes that were required to it. Because we have proceeded step by step in making those changes it is not always recognised just how extensive the cumulative process of tax reform in this country has been over the last six years, nor how radical and far-reaching many of the improvements will prove to be. So let me try to put the changes into better perspective.

TAX REFORM: 1979-1983

7. The tax system which we inherited in 1979 was widely recognised as both confiscatory and stifling economic growth rather than encouraging it. The previous Labour Governments had over many years introduced a whole plethora of new taxes, as well as increasing the burden of existing taxes, in order to finance an ever-growing public sector. The result was inevitable: far too many taxes levied at rates which were too high, and which in many cases simply distorted and depressed economic activity. The starting point for income tax, for example, was too low, drawing into the tax net people who should never have been there. Absurdly high top rates of income tax, coupled with a fierce régime of capital taxes, discouraged businessmen and wealth creators of every kind. Special reliefs, introduced to mitigate the worst effects of these high rates, served only to produce further economic distortions, to reduce the tax base, and to complicate the tax system without discernibly reducing the perceived tax burden. The size of the Revenue Departments required to administer these taxes had increased and taxpayers and their advisers faced heavy compliance demands.

Mr. Nigel Lawson, Conservative Member of Parliament for Blaby (Leicestershire), is Chancellor of the Exchequer and a member of the Cabinet and of the Privy Council.

Nigel Lawson was born in 1932 and was educated at Westminster and Christ Church, Oxford, where he read Philosophy, Politics and Economics (PPE), graduating with first-class honours in 1954. After two years' National Service with the Royal Navy he embarked on a journalistic career, including appointments with the *Financial Times, Sunday Telegraph* (city editor, 1961 to 1963) and the *Spectator* (editor, 1966 to 1970). During 1963 to 1964 he served as Special Assistant to the Prime Minister, Sir Alec Douglas-Home. He is a former Fellow of Nuffield College, Oxford.

Mr. Lawson was elected member for Blaby in 1974. He was appointed an Opposition Whip in 1976 and an Opposition spokesman on Treasury and economic affairs in 1977.

He was appointed Financial Secretary to the Treasury following the return to office of the Conservatives after the general election of May 1979. He was made a Privy Counsellor in the 1981 New Year Honours List. He was Secretary of State for Energy from September 1981 until his appointment as Chancellor of the Exchequer following the general election of June 1983.

Mr. Lawson's publications include *The Power Game* (with Jock Bruce-Gardyne, 1976); contributions to *Britain and Canada* (1976) and *The Coming Confrontation* (1978); and (a pamphlet) *The New Conservatism* (1980).

He is married.

8. In his 1982 article Geoffrey Howe described the start he had made towards his objectives of reducing the burden of direct taxation, encouraging wealth creation and simplifying tax administration. During his time as Chancellor, to encourage personal incentives, he made an important shift in the burden of personal taxation away from earnings towards spending. He cut the marginal rates of income tax at all levels. The basic rate of income tax (the marginal rate for the great majority of taxpayers in the United Kingdom) came down from 33% to 30%, the top rate on earnings from 83% to 60% and on investment income from 98% to 75%. Despite the particularly difficult economic circumstances of 1981, when the revalorisation of personal allowances was not possible, he succeeded in raising the starting point for income tax over the period 1979-1983 by 6% in real terms. He also cut the national insurance surcharge (the payroll tax on employers introduced by the previous Labour Government) progressively from 3½% to 1%; and moderated the capital tax régime.

9. Alongside these much needed tax reductions he also introduced a number of imaginative measures aimed at removing obstacles hindering the development of small firms and the expansion of other businessses. Notable among these was the highly successful business start-up scheme, and its successor, the business expansion scheme, for encouraging individuals to invest venture capital in the equity of small, unquoted companies.

TAX REFORM: 1983-85

10. In my first two Budgets I have built my own tax reforms on the foundations laid during the previous four years. Geoffrey Howe's objectives of cutting the tax burden, improving personal incentives, encouraging enterprise and wealth creation, and simplifying the tax system remain as important today as they were when he wrote in 1982. And many of the reforms which I shall describe in a moment were consistent with those broad aims. But the precise focus of tax reform naturally alters with the passage of time and with changing economic and social circumstances. So before coming to my own changes I must say something about the particular objectives I have had in mind over the last two years.

OBJECTIVES

11. First, I have sought to continue to reduce the burden of direct taxation – the taxes on income and on capital. My aim is to provide greater rewards for work, enterprise and risk-taking. It also reflects the no less important objective of achieving a better balance between the direct and indirect taxes. For we believe it is important to widen the range of people's freedom of choice by shifting the emphasis towards taxing what people spend, rather than what they earn or have saved.

12. Second, as part of the Goverment's wider policy of improving the supply side of the economy, I have sought to make changes which will improve our economic performance over the long term. An important part of this is creating the conditions in which the total weight of taxation can be reduced as resources for that become available – and this in turn means containing the pressures for public expenditure. But it has also involved reducing or eliminating a number of outdated and distortionary exemptions and special reliefs long overdue for reform. By sweeping these away we can achieve the double advantage of a broader tax base with lower tax rates all round and fewer fiscal distortions. For the less decisions in the economy are artificially distorted by tax considerations the more efficiently can resources be allocated.

13. My third objective has been to encourage enterprise of all kinds and at all levels. The role of Government here is to prepare the ground in which enterprise can best flourish: by removing obstacles to the effective working of markets in general and – given the unemployment problems currently facing the U.K. in common with most industrialised countries – the labour market in particular. To this end we have followed policies designed to improve training opportunities, particularly for the young. And I have aimed to construct a pattern of taxation that improves incentives, encourages people to take work, and makes it easier for businesses to provide more jobs.

14. Finally, I believe it is of great importance to find ways to make the tax system both simpler to understand and easier to administer. Not just because there is no virtue in complexity for its own sake, but because a simpler system reduces compliance costs for taxpayers and the cost of administration for Government. Both are important.

BUSINESS TAXATION

15. Last year, in my first Budget, I introduced a major reform of business taxation designed to encourage profits and to set out the main lines for some years ahead. The changes had four interlocking elements. First a progressive reduction in the main corporation tax rate from 52% to 35% over four years and an immediate reduction in the small companies rate (which applies to the great majority of companies, those with profits up to £ 100,000) from 38% to 30%. Second the complete abolition of the national insurance surcharge. Third, the progressive reduction of first year and initial capital allowances – which had for many years provided through accelerated depreciation a tax subsidy for a wide range of capital assets – and their replacement by annual writing down allowances much closer to commercial depreciation. And, finally, the abolition of stock relief whose justification had disappeared with the sharp fall in inflation.

16. Over the longer term these changes should result in lower tax bills for companies as the depreciation allowances under the new system build up at the same time as the lower corporation tax rates take increasing effect. But, equally important, these changes will greatly reduce the extent of the discrimination in the tax system between the use of capital and labour, between diffe-

rent types of capital investment and between different forms of financing.

17. Why was it necessary to reduce the allowances for investment? Although the pre-1984 arrangements provided a wider range of treatment for different assets, there is no doubt that overall U.K. companies received a substantially greater tax subsidy on investment than those in most other countries. Yet despite this, levels of investment in the U.K. have not been notably high by international standards and rates of return have compared unfavourably. There can be little doubt that at least in part this reflected the excessive influence of tax considerations over commercial considerations. The changes last year make investment decisions much more responsive to market signals: by largely eliminating the tax-subsidy element of accelerated depreciation, by bringing the effective treatment of equity and loan finance more closely into line and, through the ending of the National Insurance Surcharge, by removing the unjustified tax penalty on the employment of labour. The results should be to increase the quality and productivity of investment (by no longer encouraging investment only profitable because of the tax subsidy); to encourage profits; and to bring about increased employment.

SAVINGS AND INVESTMENT

18. I have also introduced a range of reforms to improve the quality and direction of savings and investment and to suport our wider policies for encouraging the development of a property and share owning democracy in which decisions are taken directly by individuals rather than by the financial institutions on their behalf. I have abolished the 15% surcharge on investment income, which to a large extent fell on savings made out of hard-earned and fully taxed income, and ended the tax subsidy on life assurance premiums for new policies taken out after the 1984 Budget. I have reduced the rate of stamp duty to encourage home buyers and equity investors and to improve the competitiveness of our stock market which the process of modernisation is opening increasingly to international competition. And I have introduced arrangements for the deduction of tax at source from bank deposit interest to bring it into line with interest on building society shares and deposits and so encourage freer competition between banks and building societies.

PERSONAL TAXATION

19. In personal taxation I have, both last year and this, given the raising of thresholds priority over a reduction in rates. The basic income tax personal allowances are now 20% higher in real terms than they were in 1978/79 and the married man's allowance is at its highest level in real terms since 1945.

20. Although we have already swept away a considerable number of long-standing discriminatory special reliefs, we have not hesitated to introduce closely-targeted incentives for which there was a clearly identified need. For instance, we have provided particularly favourable tax treatment for employee profit sharing and share option schemes because it is vital that employees should be more closely involved in the fortunes of their employers. That can transform attitudes at work benefiting the business and the nation as a whole. As a result of the changes we have made all-employee share schemes have increased from 30 in 1979 to over 900 today. And in 1984 I introduced a new share option scheme designed to help companies attract top calibre managers and to increase incentives for and motivate key personnel. Already well over 1300 schemes have been introduced. Like many of the other reforms I have described, these initiatives should have an increasingly beneficial effect on our economic performance in the years to come.

CAPITAL TAXES

21. Geoffrey Howe was able to mitigate some of the worst effects of the oppressive capital taxes which we inherited, and I am glad to have been able to carry that process further. I have abolished this year the special tax on development gains – the Development Land Tax. It was a particularly complex tax, with high administrative costs, and its principal effect was the economically damaging one of delaying the bringing forward of land for development purposes. I have also made substantial changes this year to the indexation provisions for the capital gains tax which will ensure that increasingly the tax will only be levied on real rather than inflationary gains. And I have substantially reduced the effect of capital transfer tax by lowering the top rate of tax from 75% to 60% and reducing the lifetime rates so that they are never more than half the rates which apply on death.

VALUE ADDED TAX

22. In his first Budget, as I have said, Geoffrey Howe shifted the burden of tax towards spending and away from earning by increasing the rate of VAT, previously either 8% or 12½%, to 15% at the same time as he cut income tax rates across the board. I have continued that process by extending the VAT base to include building alterations, hot takeaway food and drink, and newspaper advertisements.

ENFORCEMENT

23. In 1980 we set up an independent Committee under Lord Keith of Kinkel to review the enforcement powers of the Revenue Departments and to consider whether they were adequate to ensure compliance with tax law and at the same time avoid excessive burdens on taxpayers. Following the report of the Committee and extensive consultations subsequently I introduced in the 1985 Finance Act a balanced package of measures based on the Committee's main recommendations for

the indirect taxes. When they are fully operational they should improve compliance dramatically, cutting the amount of VAT outstanding by half. Consultations on the direct taxes are continuing and I hope to legislate on them in 1986. When complete these reforms should give us more efficient enforcement rules which are at the same time more in tune with the needs of modern society.

SIMPLIFICATION

24. Valuable simplification and administrative economy will follow from many of these reforms – abolition of entire taxes, sweeping away of obsolete discriminatory reliefs, and substantial raising of tax thresholds. But I have also brought forward a number of changes where these benefits were of particular significance. I will mention just two examples. This year a substantial simplification is being made of our ancient and elaborate stamp duties which will see an end to 15 separate duties. The system of deduction of tax from bank interest which I have already mentioned will also be a useful simplification for many taxpayers as well as providing the means of large staff savings in the Inland Revenue.

NATIONAL INSURANCE CONTRIBUTIONS

25. Although National Insurance contributions are not a tax, because they earn entitlement to social security benefits, they have many of the characteristics of a tax and so deserve to be mentioned. In this year's Budget I introduced a major restructuring of National Insurance contributions to tackle unemployment by cutting the costs of employing the young and unskilled and at the same time increasing their own incentive to work at wages employers can afford. A new system of graduated rates of contribution takes effect from October 1985 which will substantially reduce the burden of contributions on the low paid and their employers. These changes will reduce the cost of employing more than 8½ million workers by up to 5½% and increase the take home pay of some low paid workers by as much as £ 3.00 per week, thus substantially reducing disincentives to employment.

SUMMARY OF MAIN CHANGES SINCE 1979

26. Under the Conservative Government tax reform has been proceeding steadily year by year, step by step, rather than by way of a single comprehensive package of reforms embracing every aspect of taxation. Because it has been a relatively gradual process it is all too easy to lose sight of just how much has been achieved in the last six years. So let me attempt to summarise the progress so far:

- on income tax, we have raised thresholds by 20% in real terms, reduced the number of separate tax bands (including those for investment income) from 13 to 6, and reduced the top rate of tax by more than one-third;
- we have put more of the weight on taxes on spending, so lightening that on earnings and savings;
- we have enacted a simpler, less discriminatory system of business taxation in which the main rate of corporation tax is coming down from 52% to 35% and the small companies rate has been reduced from 42% to 30%;
- we have abolished three taxes altogether – national insurance surcharge, investment income surcharge, and development land tax;
- the rate of stamp duty has been halved, and we have begun the process of modernising and simplifying these duties;
- the capital taxes have been substantially reformed and lightened. For example capital transfer tax is only payable on transfers of over £ 67,000, compared with £ 25,000 in 1978/79, and lifetime cumulation has been abolished; while for capital gains tax the annual personal exemption has been increased over the same period from £ 1,000 to £ 5,900, and no tax is payable on purely inflationary gains arising since 1982;
- we are well on the way to a more efficient and modern compliance régime;
- National Insurance contributions have been restructured to encourage employment.

These changes, along with the introduction of many more efficient procedures and improved working methods, have enabled substantial economies to be made in the Revenue Departments. The Inland Revenue, which in March 1979 had almost 85,000 staff, now employs close on 70,000; and, despite the widening of the indirect tax base, Customs and Excise have been able to reduce staff by over 11% since 1979.

TAX REFORM IN OTHER COUNTRIES

27. Of course, the U.K. is not alone in giving a high priority to tax reform, and it is encouraging to see the extent of agreement on common features. Other OECD countries, including the U.S.A., are currently reviewing their tax systems with the same object in view. Although the economic, social and tax structures of these countries differ the problems they have experienced seem frequently to have been very similar. And the broad thrust of the solutions proposed seems strikingly similar to the underlying objectives of the reforms we have been implementing here since 1979.

28. Many of them look to a widening of the tax base accompanied by a lowering of tax rates. Most are intended to be broadly revenue neutral, but involve some redistribution of the tax burden. On personal income tax many proposals envisage a widespread reduction or removal of tax reliefs, with a restructuring of the rate schedule to reduce the number of income tax brackets and the top rates of tax; and a more even handed treatment of different types of income. For corporate taxation, as here, the common features include the removal of tax incentives which bias investment decisions linked to proposals for lower rates of tax.

29. I hope that other countries which are contemplating reform on these lines will find something of interest – and indeed encouragement – in what we have achieved in the last six years. But, needless to say, reform in the U.K. is not yet complete and I would like to end with a few comments on a major change I have in mind for the future.

THE FUTURE

30. For the last 40 years we have operated a Pay As You Earn (PAYE) system which collects the income tax liability of the majority of taxpayers in Britain. By 1988 the administration of PAYE will be fully computerised and that will open up a range of options for change which under the present largely manual system would not be feasible. So now is the right time to start thinking about radical changes which we may want to make in the personal tax system. I shall therefore be issuing a Green Paper, a consultative document, outlining some of the main options later this year.

31. The Green Paper will cover a number of possibilities. For example, it will look at the pros and cons of a closer alignment and working together of the tax and social security sytems. The social security system is also being computerised and in a way that is compatible with the computerisation of PAYE.

32. In particular, the Green Paper will discuss the possible new system of personal allowances which I outlined in my Budget Speech in March. The present position – very broadly – is that a single person gets one allowance, a married man one and a half allowances, and a married couple where the wife works two and a half allowances. Under the proposed new system everyone – man or woman, married or single – would have the same personal allowance. But married people with insufficient income fully to use up their own allowance would be able each year to transfer the unused balance to their spouse. This arrangement would have several advantages over the present system. It would end the present discrimination against married couples where the wife stays at home, for example to look after the children. It would end the aggregation of a married woman's income with that of her husband – both for earned income and investment income. It would give married women the same opportunity for privacy and independence in their tax affairs as their husbands have always enjoyed. And for any given reduction in taxation it would allow far more people to be taken out of the tax net altogether than under the present system.

33. Any changes of this kind would have important social and economic implications as well as representing a major reform of our personal tax system. I very much hope therefore that the Green Paper will engender a good deal of careful, thoughtful discussion of the important issues involved.

CONCLUSION

34. The path of tax reform is never easy, nor the journey free from risk. But, so long as the direction is clear, and the route carefully mapped, the traveller can proceed. My reforms have been guided by two basic principles: the need to make changes that will improve our economic performance over the longer term, and a desire to make life a little simpler for the taxpayer. We have already come a long way in reshaping our tax system. But there is more to do, and I hope to continue the process of reform – and indeed of tax reduction – in the years ahead.

The Policy and Practice of the United Kingdom in the Tax Treatment of Transfer Pricing

By M.H. Collins

THE ARM'S LENGTH APPROACH

The term "transfer pricing" is usually employed to describe the policies governing the prices charged in transactions between associated enterprises, and, in particular, between companies in a multinational or transnational group. To a large extent such a group is able to determine these prices for itself without reference to external pressures and in a manner designed to meet the convenience of the group as a whole. The prices charged will not necessarily therefore produce, in the accounts of any particular company, a figure of profit or loss which is on the same basis as the profit or loss which would be made as a result of similar transactions between independent parties. Such disparities could, if nothing were done about them, give rise to inequity between different kinds of taxpayer. Quite apart from this there is, from the tax authorities' point of view, an obvious possibility that the profit or loss arising to the company will be manipulated to secure a tax advantage for the group. The U.K. law has to take account of these possibilities, and, therefore, in common with that of many other countries, provides that transfer prices may be adjusted for the purposes of arriving at the taxable profit or allowable loss of a domestic taxpayer. The prices to which they may be adjusted are generally referred to as "arm's length prices". The arm's length price in any transaction is the price which might have been expected if the parties to the transactions had been independent persons dealing at arm's length. This manner of dealing is not defined in any statute but it may perhaps be broadly described as the normal commercial manner of dealing, unaffected by any special relationship which might exist between the parties.

UNITED KINGDOM LAW ON TRANSFER PRICING

The tax law governing these questions in the U.K. is largely contained in Section 485 of the Income and Corporation Taxes Act 1970. (This legislation consolidates earlier provisions: the statutory ancestor of Section 485 was introduced in the 1951 Finance Act.) There are special provisions which deal with the transfer prices of oil companies, but these too provide for arm's length prices to be used for tax purposes.

Section 485 provides that where any property is sold and
(a) the buyer is a body of persons over whom the seller has control, or the seller is a body of persons over whom the buyer has control, or both the seller and the buyer are bodies of persons and some other person has control over both of them and
(b) the property is sold at a price less than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length,
then, in computing the income, profits or losses of the seller for tax purposes, the like consequences shall ensue as would have ensued if the transaction had been a transaction between independent persons dealing at arm's length.

Maurice Collins was born in 1922 in Nottingham. He is an M.A. of Oxford University, and entered the U.K. Inland Revenue Department in 1948. Between 1973 and 1982 he served as an Assistant Secretary in the International Tax Policy Division of the Inland Revenue Head Office, during which time he was, inter alia, associated with the production of the 1979 O.E.C.D. Report on Transfer Pricing and Multinational Enterprises, and, as a member of the U.N. ad hoc Group of Experts on Tax Treaties between Developed and Developing Countries, in the finalisation of the U.N. Model Double Taxation Convention. Since retiring from the public service of the U.K. in 1982 he has continued to be associated with work on transfer pricing and other aspects of taxation in the O.E.C.D., and to be a member of the U.N. Group of Experts on International Co-operation in Tax Matters. He is one of the two General Reporters for Subject I (Taxation of Non-Residents) at the 1985 Congress of the International Fiscal Association.

Note: This article has no official status: although care has been taken to ensure that it is, as far as possible, accurate, it does not necessarily reflect the view of the U.K. tax authorities.

Section 485 also provides, similarly, in the case of the buyer, that, if in such a transaction between associated enterprises, property has been sold at a price higher than the arm's length price, the consequences for the buyer should be the same as if the arm's length price had been paid.

These provisions are applied also, with the necessary adaptations of language, to lettings and hirings of property, grants and transfers of rights, interests or licences, and the giving of business facilities of any kind. Loan interest, patent royalties, management fees, and payments for services are thus regarded as within the scope of the statute, as well as payments for goods. Contributions by a subsidiary towards costs incurred by the parent company or other companies in the group are similarly regarded as within its scope.

Section 485 applies in certain very limited circumstances when both parties to the relevant transaction are U.K. residents, but its importance arises mainly in the context of transactions between a U.K. taxpayer and a non-resident.

For the purposes of this legislation a "body of persons" includes a partnership as well as a company, and the references to both the seller and the buyer being bodies of persons and some other person having control over both of them, include, it was made clear in Section 17(2) of the 1975 Finance Act, cases where both of them are bodies of persons and are under the control of the same persons.

The residence of a company for U.K. tax purposes is a question of fact and is not defined in statute law. The general rule which can be discerned from the decisions of the courts is that a company is resident where the central control and management of its trade or business is carried on. Control of a company has to be distinguished from the control or management of its trade or business. For the purposes of Section 485, control of a company is defined to mean, in particular, as in Section 534 of ICTA 1970, the power of a person (including a company) to secure that the affairs of the putatively controlled company are conducted in accordance with his (or, in the case of a company, its) wishes. That power may reside inter alia in the fact that the person holds shares or possesses voting power in relation to that company or any other company, or it may reside in powers conferred by the articles of association of the company or any other document regulating that or any other company.

Thus, to take some simple examples, Section 485 clearly applies to transactions between a U.K. resident company and a non-resident "parent" company owning 51% or more of the voting shares in the U.K. company. It applies to transactions between a U.K. resident company and a non-resident company 51% of the voting shares in which are owned by a company (whether resident or not) which also owns 51% of the voting shares in the U.K. company. But it also applies in a wide range of other situations where the transactions are between connected or associated companies.

U.K. TAX TREATIES AND TRANSFER PRICING

The U.K. has about 80 comprehensive agreements with other countries for the relief of double taxation. All of these agreements contain a provision on the lines of Article 9(1) of the O.E.C.D. or U.N. Model Double Taxation Conventions (the "associated enterprises article"). This provides that "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."

These Articles allow Section 485 to operate in relation to transactions between U.K. residents and associated enterprises in the other treaty partner country, and accept the right of the partner country tax authority to make similar adjustments to transfer prices in arriving at the tax liability of its residents.

THE U.K. TAX AUTHORITIES AND THEIR PROCEDURES

The relevant U.K. tax authorities are the Board of Inland Revenue. The Board maintains a network of local tax offices spread over the whole of the U.K. and, normally, the affairs of any taxpayer will be mainly dealt with by a local Inspector of Taxes. But transfer pricing problems involving substantial amounts of money or important matters of principle will be dealt with, instead, by a section of the Central Head Office in London. Part of the function of this section is in any case, moreover, to advise local offices on transfer pricing matters. Where such matters arise in connection with oil companies they will normally however be dealt with by the centralised Oil Taxation Office, also in London.

The objectives of both central and local offices are however the same – to ensure that the U.K. taxpayer is paying the proper tax on its profits under the U.K. law.

The question of adjusting transfer prices and the possible implementation of Section 485 would normally arise in the course of the examination of the U.K. taxpayer's accounts in preparation for the Inspector of Taxes' assessment of the tax liability on the profits of the company for the chargeable period. The U.K. system of taxing profits differs from the systems employed by some other countries under which the tax authorities have a free access to the taxpayer's books and records and audit them for tax purposes as a matter of course.

The U.K. system, although it allows for audits by the tax authorities in certain restricted circumstances, does not rely on such audits. Instead it requires the taxpayer to make a return of his profits each year to the appropriate Inspector of Taxes. It is normal for this return to be accompanied by accounts and computations in some detail in order to substantiate the return. But the Inspector, if no return is made, or if he is dissatisfied with a return which has been made, is empowered to assess the liability to tax on the basis of his own estimate of the profits. The taxpayer is protected from arbitrary assessment by a right of appeal. This may be made in the first instance to independent Commissioners. These are the final authority on questions of fact but on a point of law the taxpayer may appeal from them to the judges of the High Court and from them, if need be, to the Court of Appeal and, beyond them, to the House of Lords. Hitherto however it has been rare for transfer pricing issues to go to appeal Commissioners for hearing.

In an appeal the onus of proof is on the taxpayer in the first instance to disprove the correctness of the Inspector's assessment and not for the Inspector to prove that it is correct. If the Inspector takes the view that it may be necessary to assess the profit on the basis of his own estimate he will normally, however, in any case where substantial amounts are at stake, seek to come to an agreement with the taxpayer. Only if he cannot do this will it be necessary for the Commissioners or the courts to be brought into the matter.

An assessment of a company's profits may be made at any time within six years from the end of the chargeable period to which the assessment relates. Consequently there ought to be a good margin of time in which the necessary information can be provided and the relevant discussions can take place in order to achieve an agreement. However it may be necessary for one reason or another for the Inspector to make the assessment without reaching agreement. Nevertheless, provided that the taxpayer appeals against the assessment within the thirty days allowed by law, it is still possible for discussions to be continued – or even to be begun – and for the assessment to be adjusted by agreement. It would normally be the Inspector's practice to continue to seek agreement, rather than list the appeal for hearing by Commissioners, as long as it seemed likely that an agreement could be reached within a reasonable time.

It is possible too for the Inspector to make additional assessments at any time within six years of the end of the relevant accounting period if he discovers that any profits which ought to have been assessed to tax have not been assessed or that an assessment to tax has become insufficient, or that any relief from tax which has been given is or has become excessive. (The taxpayer has the same rights of appeal against an additional assessment as he would have against a first assessment.) In consequence, it would be possible, as the result of the review of the transfer pricing of a company relating initially to one year, that additional tax could be charged for up to six earlier years (more if fraud was involved). Whether in practice adjustments would be made for earlier years would depend on the facts and circumstances of the particular case. It would not necessarily follow that because adjustments were needed for one year they were needed for earlier years as well.

INFORMATION REQUIREMENTS

In any case in which the tax authorities decide that it is necessary to examine the transfer prices of a taxpayer it is likely that they will need to elicit additional information. How much and what kinds of additional information they will call upon the taxpayer to provide will vary with each particular case. The U.K. authorities employ no standard list of questions. But they will generally be interested in the first place in such matters as who owns or controls the company, what the nature of the trade is, how any group of which the company is a member is organised, what are the functions of particular companies in the group, how far the profitability of particular companies has come up to expectations etc. It is possible too, depending on the facts and circumstances of the case, that at some stage the relevant Inspector will need to enquire for example into the open market prices of goods or services comparable to those provided by the taxpayer or its associates, into the costs of production of goods acquired by the U.K. taxpayer or the costs of research and other services which are paid for or utilised by the U.K. taxpayer, or into the prices at which goods processed by the U.K. company are subsequently sold by their purchasers, and so on. But the need, if any, for answers to such detailed questions would usually emerge as discussions proceeded.

INFORMATION SOURCES

The initial responsibility of the taxpayer to disprove the Inspector's assessment means that the Inspector can often, within reasonable limits, operate a powerful lever to persuade the taxpayer to provide the information needed to arrive at a mutually acceptable solution of any dispute about an assessment. But the Inland Revenue have, in addition, statutory powers to require the production of information for tax purposes. Section 17 of the 1975 Finance Act relates specifically to transfer pricing matters. It empowers the Board of Inland Revenue to require a company to produce information which is relevant to its own transfer prices and also information which is relevant to the transfer prices of other companies whether such companies are associated with it or not. The Section empowers the Board to require the production of books and accounts, in certain circumstances, where the relevant U.K. company has had transactions with a 51% subsidiary resident outside the U.K. This could include books and accounts of the subsidiary. (A 51% subsidiary for this purpose is a company 51% or more of the ordinary share capital of which is owned directly or indirectly by the U.K. resident company.) The power extends also to enable the Revenue to require the parent company to produce such information where the transactions take place between the non-resident subsidiary and any other 51% subsidiary of the U.K. parent. (The U.K.

parent may however appeal against these requirements to produce books and accounts etc. of a non-resident company to the Special Commissioners – a body of independent tax appeal Commissioners based in London.) In addition to these powers Section 17 authorises the Board of Inland Revenue to require a taxpayer to produce books and accounts and other documents or records, which are relevant to a transfer pricing adjustment under Section 485, for examination by an Inspector of Taxes on the taxpayer's premises – an example of the limited powers of audit of the U.K. Inland Revenue. The powers provided by Section 17 are supported by financial penalties for non-compliance. They are rarely however used. It has normally been possible in practice for the Revenue to procure adequate information to reach a settlement in transfer pricing matters without invoking Section 17.

CONFIDENTIALITY OF INFORMATION

Officers of the Inland Revenue are governed by very strict rules about the confidentiality of information received by them in the course of their duties. They are prohibited from disclosing such information except for tax purposes (and certain very minor and restricted other purposes specified in statute). Moreover the limits of any possible disclosure for tax purposes outside the Inland Revenue are also strictly defined by law. It is relevant in the context of transfer pricing that disclosure is statutorily permitted to the Customs and Excise authorities. But probably the most important permissible disclosure in this context is disclosure to the tax authorities of other countries under agreements for the relief of double taxation and under the Directive concerning mutual assistance between tax authorities of the member states of the European Communities (the EEC).

The U.K.'s comprehensive double taxation agreements all contain a provision on the lines of Article 26 (the exchange of information article) of the O.E.C.D. Model Double Taxation Convention. These provisions enable information to be exchanged between the competent tax authorities of the treaty partners for the purposes of carrying out the provisions of the treaty, including the adjustment of transfer prices under the equivalent of Article 9(1) of the O.E.C.D. Model. The Articles provide that the information is to be used for tax purposes only and otherwise kept secret. The information which can be exchanged excludes information which would disclose business secrets.

The U.K. has double taxation relief agreements with all its fellow member countries of the EEC, but the EEC Mutual Assistance Directive of 19 December 1977 also provides that the competent tax authorities of the EEC member states shall exchange any information that may enable them to effect a correct assessment of taxes on income or on capital and it particularly requires the provision of information without prior request where the competent authorities of a member state have grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises. The secrecy of information provided under the Directive is also strictly protected as it is under the tax treaties. Under the Directive, too, as under the treaties, information would be refused if it would lead to the disclosure of a business secret. Legislation to enable the U.K. Inland Revenue to comply with this Directive was introduced in the Finance Act of 1978 (Section 77).

These instruments of course enable the U.K. tax authorities to receive information from other tax authorities as well as to give it to them. The U.K. Inland Revenue has been cautiously developing its exchanges of information with other countries over the last 15 years or so. One of the objects of this has been to improve the understanding of its officers of the general background to the trading and investment activities of the multinational enterprises which are U.K. taxpayers as well as to acquire knowledge of the specific facts relating to particular transfer prices. This they hope will enable them to negotiate acceptable adjustments of transfer prices, where adjustments are necessary, more smoothly than they might be able to do otherwise. The Inland Revenue know that fears have been expressed that increased exchanges of information between tax authorities may lead to unjustified proposals to revise transfer prices, either because the information is inaccurate in itself or because of the failure of the tax authorities to see it in its proper context. In general the Inland Revenue take the view that the better informed their officers are the less they are likely to raise unnecessary enquiries or make wrong judgments. They therefore have seen increased exchanges of information as quite possibly having a beneficial result, at any rate for some taxpayers. But they understand the fear of multinational enterprises that it may unjustifiably have the contrary result, and it is for this reason, among others, that they are concerned to deal with these matters as informally as possible by discussion and negotiation. However they would emphasise in any case that the appeal provisions in the tax law would give the taxpayer, in the last resort, the opportunity, if need be, to correct or supplement any information having a bearing on the matter.

INLAND REVENUE'S APPROACH TO THE INVESTIGATION OF TRANSFER PRICES

The Inland Revenue recognise that an onerous burden may be imposed nevertheless on the senior staff of companies and their advisers if they are called upon to answer the many detailed questions which may necessarily have to be asked in order to conclude a satisfactory review of a company's transfer pricing. They have however indicated that they aim to keep these questions to a minimum by concentrating on the main pricing issues involved. Thus they would not necessarily seek to investigate the transfer pricing of every kind of transaction undertaken by the taxpayer but might concentrate their attention on a single or a small number of important activities. They might accept too that in some circumstances it would be convenient to analyse the transfer pricing for product lines or other groupings of goods or services rather than to seek to ascertain an arm's length price for each individual product or supply. In general, if the prices actually paid can be substantiated as being reasonably close to arm's length prices they would not seek to make minor or marginal adjustments, and they would hesitate to disturb without good reason a pricing arrangement reasonably and consistently operated between associated enterprises if it is also reasonably and consistently operated in comparable dealings with independent parties.

They have also indicated that they recognise too that the evidence needed to establish an arm's length price may be hard to come by and difficult to interpret, and that decisions on pricing in the arm's length situation would have to be taken in the light of the facts which could have been known at the time when the decision was made. They would seek therefore to avoid in any way substituting their own commercial judgment for that of the taxpayer. But they do seek to make the best assessment they can of the arm's length profits in the light of all the evidence.

PUBLISHED GUIDELINES

The U.K. law does not provide any detailed rules about the treatment of transfer prices in particular situations to supplement the general rules set out in the statute. There is little formal guidance therefore to indicate how the Inland Revenue will approach any particular transfer pricing issue. It is not their practice to give advance rulings or to commit themselves to a course of action on the basis of hypothetical considerations. On the other hand their expressed hope is that in any case where they have reviewed a company's transfer pricing and discussed it with the company, the result of their discussions would be to establish a reasonable basis of understanding with the company for the future (possibly on the basis of a further review after a number of years).

Nevertheless the Inland Revenue have published a brief note outlining their approach to transfer pricing, which is available from the Public Enquiry Room at Somerset House, Strand, London WC2R 1LB, and taxpayers may derive a certain amount of guidance from this.

It indicates, inter alia, that the Inland Revenue's approach to these matters is flexible and pragmatic. In ascertaining an arm's length price they will clearly look, where it is practicable to do so, for evidence of prices in similar transactions between parties who are in fact operating at arm's length. They may however find it more useful in some circumstances to start with the resale price of the relevant goods or services etc. and arrive at the arm's length price by deducting an appropriate mark-up. They may find it more convenient on the other hand to start with the cost of the goods or services etc. and arrive at the arm's length price by adding an appropriate mark-up. But they will in practice use any method which seems likely to produce a satisfactory result.

O.E.C.D. TRANSFER PRICING REPORT

An important statement in the Inland Revenue's note is that they will be guided in their search for an arm's length price by the considerations set out in the O.E.C.D. Report on Multinationals and Transfer Pricing. This Report was published in 1979 and examines the considerations which need to be taken into account in arriving at arm's length prices in general and also, in particular, in the context of sales of goods, the provision of intra-group services, the transfer of technology and the provision of intra-group loans.

Thus it may be expected that the U.K. tax authorities will approach these matters broadly on the lines which are sketched out briefly in the following paragraphs.

In transfer pricing matters as in others the U.K. authorities would recognise the actual transaction entered into by the parties as the starting point for the assessment of tax liability and would not, other than in exceptional cases where altogether artificial transactions were involved, seek to disregard them or to substitute other transactions for them. For example they would not, as some other countries might do, treat payment of the excess over the arm's length price for goods received from a parent company as a constructive dividend paid by the subsidiary. They would seek to adjust the price paid for the actual transaction to the arm's length price and otherwise would not ordinarily treat transactions between associated enterprises differently from similar transactions between independent parties simply because the parties to the transaction were related.

They would recognise too that associated enterprises are able to make a greater variety of contracts and arrangements than are available to unrelated enterprises because the normal conflict of interest which exists between independent parties is absent. They would not, for example, in the context of payment for intragroup services or research, disregard a cost contribution arrangement, under which payments are made regularly for benefits received at irregular intervals, simply because such arrangements are not commonly met with in the arm's length situation. But they would seek to ensure that the payments made under such an arrangement, for which deductions were claimed, adequately reflected the arm's length price of the benefits received. (A potential benefit would be regarded as a real benefit only if the relevant party had a genuine or substantive interest in the results which the research might produce or the payment was in the nature of a retainer for services which were genuinely likely to be needed.)

On the other hand, in the case of a U.K. resident company performing services for overseas members of a group, the Inland revenue would expect such services to be provided, in the arm's length situation, at a price which included a profit element, although they would be open to argument as to how large that element might be, and as to whether it would take the form of a mark-up on the price of individual items or a more generalised service fee.

In looking at evidence for comparable arm's length prices the Inland Revenue will consider any relevant data but they will consider carefully the circumstances in which potentially comparable prices have been paid and will not necessarily regard them as automatically conclusive of the issue. They will take into account the fact that, as the O.E.C.D. Report points out, a variety of factors may have to be considered in order to ensure that the prices used are truly comparable. They will recognise for example the fact that market prices vary from one country to another and from one time to another, and that different countries' policies in relation to taxes, currency values, competition policy, price or exchange control etc. are likely to have an influence on price levels in those countries. They recognise too that consumer preferences, brand names, trademarks, guarantees and other factors may differentiate the prices of otherwise very similar goods.

They may however feel obliged to explore other methods of arriving at any particular arm's length price in cases where there is either no evidence of comparable prices (as might be the case, for example, in relation to payments for very specialised technology) or the evidence is for some reason unreliable or inconclusive (as it might be, for example, if it relates only to incidental sales to independent persons when the great bulk of sales is to other members of the group), and they might also seek to explore the results of using other methods in order to test the soundness of their reading of the evidence of comparable prices.

If they seek to arrive at the arm's length price by building it up from relevant costs they will take into account all relevant costs. Bearing in mind the acknowledged difficulties of establishing and allocating costs, they would be prepared to accept the use of average costings where this seemed reasonable. They would recognise that, in the open market, goods or services might sometimes have to be provided at a price which was not sufficient even to recover the costs involved but, on the assumption that the object of trading is to make a profit, they would need cogent arguments to persuade them that an arm's length price based on costs should not include an element of profit.

Similarly, if it is sought to arrive at an arm's length price by reference to the price at which a product which has been purchased from a related seller is resold to an independent purchaser (the so-called resale price method) they would expect the arm's length price to be one which provided a return to the taxpayer over and above the mere recovery of his costs, and they would seek to evaluate the scale and nature of the commercial activity involved in the relevant transaction on the part of the taxpayer in order to judge the adequacy of his return.

INCIDENCE OF INLAND REVENUE'S ENQUIRIES INTO TRANSFER PRICES

It has been the practice for some years now for the U.K. Inland Revenue to scrutinise the transfer pricing of particular enterprises rather more as a matter of course than was the case in earlier years. The enormous growth in the activities of multinational enterprises and the importance now attributed to the transfer pricing phenomenon both nationally in the U.K. itself and internationally in such organisations as the O.E.C.D. and the United Nations has made it necessary for the U.K. tax authorities to give it more attention than was formerly the case. Whether or not the transfer prices of any particular enterprise will be the subject of a detailed scrutiny by the Revenue will however depend on a number of factors, an important one being the availability of suitable Revenue staff. Therefore it is not possible to lay down any guidelines about the circumstances in which an enterprise may expect to be faced with such an investigation. The acknowledged difficulties which are faced by tax authorities and taxpayers alike in ascertaining the arm's length price of many items of supply mean that, in order to satisfy themselves that the transfer pricing of an enterprise is acceptable for tax purposes, the Inland Revenue may have to embark on some examination of this aspect of the enterprise's taxability even though there is no obvious reason to suppose that its transfer prices are unsatisfactory. Consequently it does not follow that, because questions are asked by the Revenue about the transfer pricing of an enterprise, they have reason to suppose that its prices are seriously out of line with arm's length prices. The Inland Revenue recognise that investigations in such circumstances will be an inconvenience for the enterprise and they will therefore do what they can to minimise the inconvenience as far as possible. But it is unlikely that they could dispense completely with the need to reassure themselves at least that more intensive scrutinity is not required. On the other hand they may receive information indicating an apparent discrepancy for example between the prices being charged or paid and prices being paid by independent enterprises and they might well feel obliged to follow this up with a more careful look at the company's tax liability.

MUTAL CONSULTATION OF TAX AUTHORITIES

Fears have been expressed that the increased interest by tax authorities across the world in the transfer pricing of multinational enterprises may result in adjustments in one country to the taxable profits of entities of a multinational enterprise which are not counterbalanced by appropriate adjustments to the profits of the relevant associated entities in another, thus giving rise to "economic double taxation" which for one reason or another cannot be relieved under tax treaties or domestic law. It is perhaps possible that these fears have been somewhat exaggerated, but it is true that this is an area in which it is not certain that relief will always be available.

Some relieving provisions are available. Article 9(2) of the O.E.C.D. Model Double Taxation Convention, for example, provides that where one contracting state makes a transfer pricing adjustment and taxes an enterprise of that state on profits which have been charged to tax by the other contracting state in the hands of an enterprise of that other contracting state, then that other contracting state should make a corresponding adjustment to the amount of tax which it has charged. In a number of the U.K.'s tax treaties, and particularly in those which have more recently been negotiated or revised, there are analogous provisions enabling the U.K. to credit the tax charged in the other country against the tax charged in the U.K. on the profits of the associated enterprise. It may also be possible in other cases for the U.K. tax authorities to prevent this kind of economic taxation from occurring in certain circumstances by taking account of the adjustment in arriving at the assessment of the profits of the U.K. enterprise if that assessment has not yet been finalised. But in either case the possibility of a corresponding adjustment would depend on whether the Inland Revenue could defend its acceptance of the original adjustment by the other country.

It may therefore be necessary for the Inland Revenue to consult the other tax authorities in this sort of case. The U.K.'s double taxation agreements normally include provisions enabling the competent tax authorities of the two countries to consult with each other directly about such matters as the implementation of the agreements, including the adjustment of transfer prices and consequent claims for relief, and there is a similar provision in the EEC Mutual Assistance Directive. The U.K. Inland Revenue frequently in fact do consult with the competent authorities of treaty partners and are very often able to negotiate a reasonably satisfactory solution to the problems discussed. They would certainly be prepared to listen to representations from the other country's tax authorities and to do whatever they could to take account of the other country's actions in this sort of situation. Similarly they would be prepared, if it seemed reasonable, to consult with the other country's authorities on the problems raised with them by the U.K. taxpayer. If they are to make representations to the other country on behalf of the U.K. taxpayer they would however normally expect the taxpayer to supplement these representations by their own direct representations wherever possibe, and of course to provide the necessary information to back up their representations.

Although the U.K. Inland Revenue is able in this way to consult with the tax authorities of treaty partner countries in order to try to solve this kind of problem, it is not however able to solve the problems simply by agreement – the solution has to be possible within the domestic U.K. law. For example, if the relevant assessment to U.K. tax is final, it will not be possible to reduce it. On the other hand, if a claim to relief is valid, it would be possible to give effect to it even though the assessment was final, provided that the claim was made within the appropriate time limit. An assessment could become final either on the determination of an appeal against it or by agreement, or, in the absence of an appeal, by the expiry of the relevant time limit for an appeal. Time limits may obviously therefore be important. An appeal against an assessment must be made within 30 days. Claims to relief for foreign tax may however be made not later than six years from the end of the chargeable period for which the income is chargeable to U.K. tax. However, where such relief has been rendered insufficient by reason of an adjustment to the other country's tax, the time limit for a claim to additional relief is six years from the time when the adjustment was made – Section 512 of ICTA 1970. Nevertheless, if the consultation process is to have any chance of producing an effective result it needs to be commenced as soon as possible.

To start such consultations by the U.K. Inland Revenue all that a taxpayer needs to do is to write a letter putting his request and giving the necessary details to the International Tax Policy Division of the Inland Revenue Head Office in Somerset House, Strand, London.

PROFITS OF PERMANENT ESTABLISHMENTS

This article has, up to this point, concentrated on prices paid by separate but associated companies. Similar problems arise in ascertaining the taxable profits made by branches and other permanent establishments of transnational enterprises. Strictly speaking, in this context, transfer prices are not involved. But, in this context too, it is necessary for a tax authority to ensure that the branch etc. pays an adequate level of tax, and in this context too, it is widely accepted internationally that the taxable profits of a branch or other permanent establishment should be those which it might be expected to make, in the words of Article 7 of the O.E.C.D. Model tax treaty (the business profits article) "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". The U.K.'s comprehensive tax treaties all include an article on these lines which in fact reflects the general approach of the U.K. domestic law in this field. The U.K. tax authorities recognise therefore that the principle of arm's length pricing is valid for the taxation of permanent establishments although, as the O.E.C.D. Transfer Pricing Report points out, the principle has to be applied with care because of the special factors involved (for example, the limitations normally recognised on the acceptability for tax purposes of loan or royalty contracts between permanent establishments and the remainder of the enterprise of which they form part). Nevertheless, to a very large extent, the approach of the U.K. Inland Revenue to the taxation of permanent establishments of overseas enterprises is similar to its approach to the taxation of subsidiary and associated companies in a multinational or transnational group and most of what is said in this article is relevant also to the U.K. taxation of permanent establishments.

APPENDIX

THE TRANSFER PRICING OF MULTINATIONAL ENTERPRISES
NOTES BY THE U.K. INLAND REVENUE[1]

1. Introduction

These notes are primarily designed for the guidance of overseas companies which have, or may be thinking of setting up, subsidiaries in the U.K.; but the law and practice described apply to U.K. resident companies generally.

2. General – the arm's length principle

Prices charged in transactions between connected companies in a multinational group (transfer prices) may be designed to meet the convenience of the group as a whole. They will not necessarily produce a figure of profit or loss which can be accepted for tax purposes. The U.K. law therefore, in common with that of many other countries, provides that these prices may be adjusted in arriving at the taxable profit or allowable loss of a U.K. taxpayer. The price to which they may be adjusted is the "arm's length price". This is the price which might have been expected if the parties to the transaction had been independent persons dealing at arm's length, i.e. dealing with each other in a normal commercial manner unaffected by any special relationship between them.

3. Circumstances in which adjustments may be made to transfer prices

The relevant law is largely contained in Section 485 of the Income and Corporation Taxes Act ("ICTA") 1970. This provides the Inland Revenue with power, for example, to adjust a transfer price to the arm's length price in transactions between a resident and a non-resident body of persons when one controls the other or both are under common control.

4. Body of persons

A "body of persons" includes a partnership as well as a company.

5. Residence of a company

The general rule is that a company is resident where the central control and management of its trade or business is carried on. The application of the rule is a question of fact.

6. Control of a company

Control of a company has to be distinguished from the control and management of its trade or business. For the purposes of Section 485 it is defined in particular to mean, as in Section 534 of ICTA 1970, the power of a person to secure that the affairs of the company are conducted in accordance with his wishes, inter alia, by holding shares or possessing voting power in relation to that company (or any other company) or by virtue of any powers conferred by the articles of association or other document regulating that or any other company.

7. Scope of U.K. transfer pricing law

Section 485 applies to sales of goods and other property lettings or hiring of property, grants and transfers of rights, interests and licences and the giving of business facilities of whatever kind. Loan interest, patent royalties, management fees, and payments for services are thus within its scope as well as payments for goods. Contributions by a subsidiary towards costs incurred by the parent company are similarly within its scope.

8. Tax returns – assessment of profits – onus of proof – rights of appeal

The U.K. system of taxing profits requires the taxpayer to make a return of his profits each year to the appropriate Inspector of Taxes. It is normal for his return to be accompanied by accounts and computations in some detail in order to substantiate the return. But the Inspector, if no return is made or if he is dissatisfied with a return which has been made, is however empowered to assess the liability to tax on the basis of his own estimate of the profits. The taxpayer has a right of appeal to independent Commissioners (and from the Commissioners, on a point of law, to the High Court and beyond) but it is for him in the first instance to disprove the correctness of the assessment in such an appeal and not for the Inspector to prove that it is correct.

9. Adjustment by agreement

If, however, the Inspector takes the view that it may be necessary to assess the profits on the basis of his own estimate he will normally seek, in any case where substantial amounts are at stake, to come to an agreement on the matter with the taxpayer either by correspondence or, very probably in a case where the adjustment of transfer prices is in point, by discussion round the table as well.

10. Requests for information

If it seems to the Inspector that it may be necessary to adjust a company's transfer prices for tax purposes he will normally, therefore, in the first place, ask the U.K. company for the information necessary to decide whether adjustments should be made and what sort of adjustments. There is no standard list of questions – each case will need to be looked at in the light of its own special features. But the Inspector will generally be interested in such matters as who owns or controls the company, what the nature of the trade is, how any group of which the company is a member is organised, what are the functions of particular companies in the group, what the results of the U.K. companies have been, how far they have come up to expectations and so on. The need for answers to more detailed questions may emerge as the discussions proceed.

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11. Powers to require information

The Inland Revenue have power in certain circumstances to require the production of information for tax purposes and, in particular under Section 17 of the Finance Act 1975, they may require a company to produce information which is relevant to the adjustment of transfer prices (not necessarily its own transfer prices) under Section 485 of ICTA 1970. Powers provided under Section 17 also include in certain circumstances the power to require the production of information (including books and accounts) from a U.K. resident company, which is relevant to transactions with a 51% subsidiary resident outside the U.K., including books and accounts of the subsidiary. This also applies where the transactions are between U.K. resident and non-resident companies both of which are 51% subsidiaries of the U.K. resident company. (The U.K. parent company may however appeal against the requirement to an independent body of Commissioners.) In addition, in certain circumstances the Board may require books and accounts and other documents or records which are relevant to a transfer pricing adjustment under Section 485 to be produced for examination by an Inspector of Taxes on the taxpayer's premises.

12. Confidentiality

Officers of the Inland Revenue are governed by very strict rules about the confidentiality of information received by them in the course of their duties. They are prohibited from disclosing such information except for tax purposes and, within that limitation, in very limited circumstances strictly defined by law.

13. Exchange of information with other countries

Disclosure is permitted (under strict safeguards) to other countries' tax authorities under agreements for the relief of double taxation and under the Directive concerning mutual assistance between tax authorities of the member States of the European Communities. (The Inland Revenue may also receive information from other countries under these instruments.)

14. Inland Revenue Organisation

The Inland Revenue maintains a network of local tax offices spread over the whole of the U.K. and normally the affairs of a taxpayer will be mainly dealt with by a local Inspector of Taxes. But transfer pricing problems involving substantial amounts of money or important matters of principle may be dealt with instead by a section of the central head office in London. (The affairs of oil companies including matters of transfer pricing are dealt with by a centralised Oil Taxation Office in London.)

15. Objectives and method of approach in adjusting transfer prices for tax purposes

The objectives of both central and local offices are however the same. The principal objective is to ensure that the U.K. taxpayer is paying the proper U.K. tax on its profits under the law. The Inland Revenue recognise, however, that answering the many detailed questions which may be necessary for the achievement of this objective may impose an onerous burden on the senior staff of companies or their advisers and they aim to keep these questions to a minimum by concentrating on the main pricing issues involved.

16. Methods of and considerations taken into account in arriving at arm's length prices

In ascertaining an arm's length price the Inland Revenue will often look for evidence of prices in similar transactions between parties who are in fact operating at arm's length. They may however find it more useful in some circumstances to start with the re-sale price of the goods or services etc. and arrive at the relevant arm's length purchase price by deducting an appropriate mark up. They may find it more convenient on the other hand to start with the cost of the goods or services and arrive at the arm's length price by adding an appropriate mark up. But they will in practice use any method which seems likely to produce a satisfactory result. They will be guided in their search for an arm's length price by the considerations set out in the O.E.C.D. Report on Multinationals and Transfer Pricing. (This Report examines the considerations which need to be taken into account in arriving at arm's length prices in general and also in particular in the context of sales of goods, the provision of intra group services, the transfer of technology and rights to use trademarks within a group and the provision of intra group loans.)

17. Settlement of problems

The Inland Revenue recognise, as does the O.E.C.D. Report, that the evidence needed to establish an arm's length price may be hard to come by and difficult to interpret and they recognise also that decisions on pricing in the arm's length situation would have had to be taken in the light of the facts which could have been known at the time when the decision was made. It is with considerations like this in mind that they are concerned to settle transfer pricing adjustments as far as possible by discussion and agreement with the companies concerned. They would hope as a result also to establish a reasonable basis of understanding with the companies for the future (possibly on the basis of a review after a number of years).

18. Consultation with other countries

The Inland Revenue recognise that transfer pricing adjustments may have a consequence not only for U.K. tax but also for foreign tax. They are able, under the terms of some seventy agreements for the relief of double taxation and the prevention of fiscal evasion, to exchange information with the tax authorities of their partner countries on transfer pricing matters among others and they often do this for the purpose of ensuring that tax is adequately charged in the U.K. On the other hand, they are also able to consult and do consult with partner countries with a view to preventing unrelievable double taxation arising from (among other causes) the adjustment of transfer prices. A taxpayer who fears that unrelievable double taxation may result in his own case from some action of the tax authorities of a treaty partner may ask the U.K. Inland Revenue to enter into such consultations and they will do so whenever the need arises. All that such a taxpayer need do is to write a letter putting his request, and giving the relevant details, to the International Tax Policy Division of the Inland Revenue in Somerset House, London. For such consultation to be effective however it will usually be necessary for the request to be made in good time so as not to be frustrated by the expiry of legal time limits for tax adjustments either in the U.K. or in the other country.

[continued on p. 372]

UNITED KINGDOM:

The Inland Revenue's Senior Management System

By M. Symons

1. For the past two years the Inland Revenue has carried out an annual review of its work through what it calls its Senior Management System (SMS). This has been a major development for top and senior management. In this article I describe how the SMS came to be introduced and what it involves. I go on to give some comments on how far it has succeeded in meeting its original objectives and to discuss some of the problems encountered and benefits gained, and some possible directions for future development. These comments represent my personal views and should not be regarded as necessarily reflecting a Departmental view.

BACKGROUND

2. The idea of a top management system was a key component in the Government's Financial Management Initiative (FMI), which the Prime Minister launched in May 1982 as a means of securing improved managerial effectiveness throughout the Civil Service. Departments were set the objective of developing

> an organisation and a system in which managers at all levels have:
> a. a clear view of their objectives; and means to assess, and wherever possible measure, outputs or performance in relation to these objectives;
> b. well-defined responsibility for making the best use of their resources, including a critical scrutiny of output and value for money; and
> c. the information (particularly about costs), the training and the access to expert advice which they need to exercise their responsibility accordingly.[1]

3. By January 1983, the Inland Revenue had produced its plans which draw on work which was already in train and to which the FMI gave an added impetus. Besides the SMS which met the requirement for a formal top management system, the plans covered the development or enhancement of management information systems throughout the Department and proposed significant changes in the means for controlling expenditure. Since then, the Department has made progress as has the rest of the Civil Service. This has been reported upon in two White Papers published in September 1983 and July 1984.[2] The first of these gives a useful comparison of how different Departments have attempted to implement their top management systems, while a more detailed report, published in 1984 by the central Whitehall unit responsible for the FMI, gives further insight into how these systems are developing.[3]

INLAND REVENUE ORGANISATION

4. Before going on to describe the format of the SMS and the annual review process, I should describe briefly the Department's current organisation. The Inland Revenue is responsible for advising Treasury Ministers on direct tax policy and for the administration of the direct taxes (principally Income Tax, Corporation Tax and the Stamp Duties). In addition it manages the Valuation Office which maintains the local property valuation lists and undertakes valuation work on behalf of other Government Departments.

M. Symons is a Principal in the Inland Revenue where he has worked for about 12 years, first in the policy area followed by a long stint on the project to computerise PAYE. For the past two years he has been attached to a small team co-ordinating work on the Department's Financial Management Initiative. He has specific responsibility for the operation and development of one facet of this which the Revenue call their Senior Management System.

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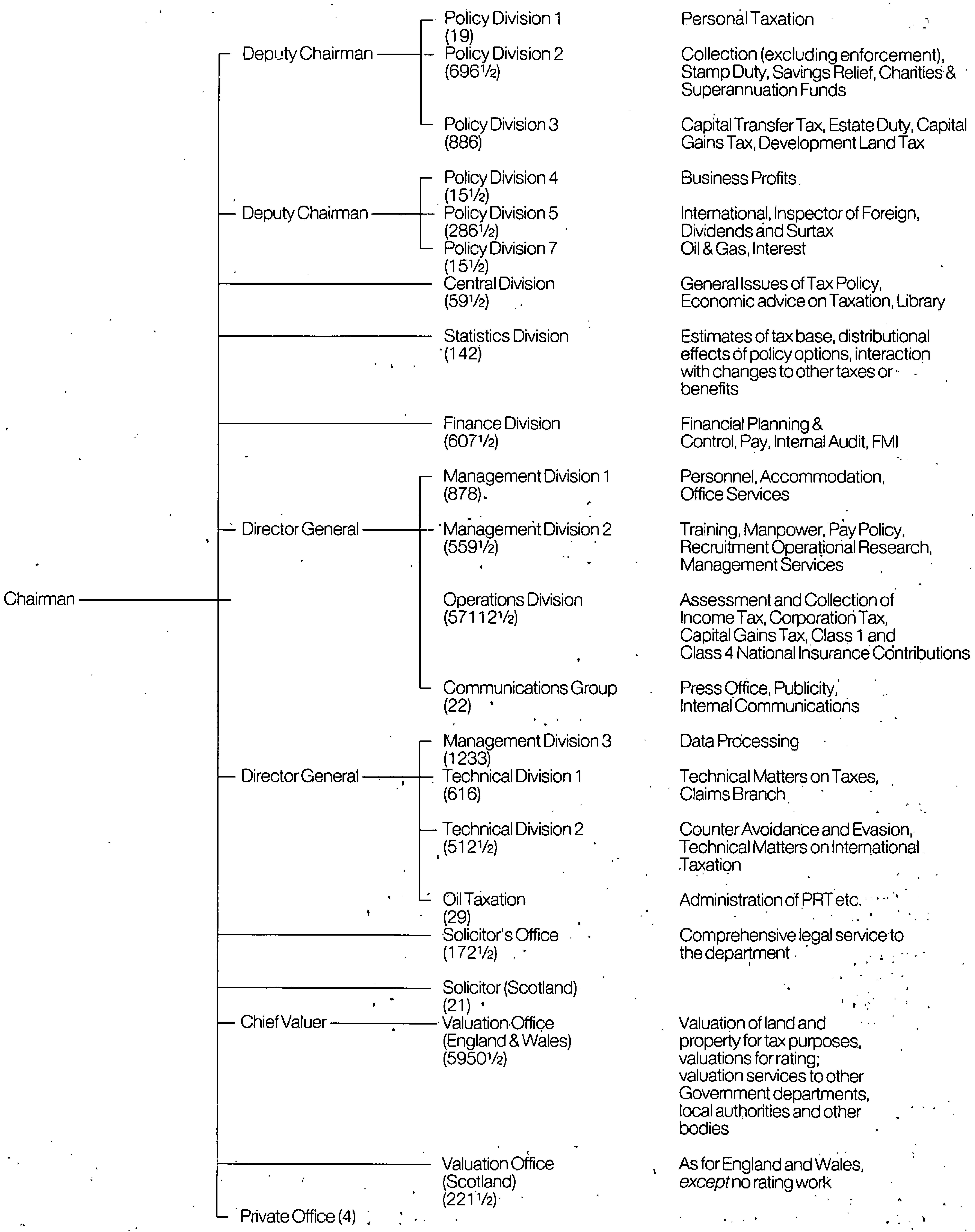
[1] Efficiency and Effectiveness in the Civil Service (Cmnd 8616), September 1982, HMSO.

[2] Financial Management in Government Departments (Cmnd 9058), September 1983, HMSO. Progress in Financial Management in Government Departments (Cmnd 9297), July 1984, HMSO.

[3] Top Management Systems, May 1984, Central Management Library, Cabinet Office.

Figure 1 – Inland Revenue Organisation



Chairman — Deputy Chairman	Policy Division 1 (19)	Personal Taxation
	Policy Division 2 (696½)	Collection (excluding enforcement), Stamp Duty, Savings Relief, Charities & Superannuation Funds
	Policy Division 3 (886)	Capital Transfer Tax, Estate Duty, Capital Gains Tax, Development Land Tax
Deputy Chairman	Policy Division 4 (15½)	Business Profits
	Policy Division 5 (286½)	International, Inspector of Foreign, Dividends and Surtax
	Policy Division 7 (15½)	Oil & Gas, Interest
	Central Division (59½)	General Issues of Tax Policy, Economic advice on Taxation, Library
	Statistics Division (142)	Estimates of tax base, distributional effects of policy options, interaction with changes to other taxes or benefits
	Finance Division (607½)	Financial Planning & Control, Pay, Internal Audit, FMI
Director General	Management Division 1 (878)	Personnel, Accommodation, Office Services
	Management Division 2 (559½)	Training, Manpower, Pay Policy, Recruitment Operational Research, Management Services
	Operations Division (57112½)	Assessment and Collection of Income Tax, Corporation Tax, Capital Gains Tax, Class 1 and Class 4 National Insurance Contributions
	Communications Group (22)	Press Office, Publicity, Internal Communications
Director General	Management Division 3 (1233)	Data Processing
	Technical Division 1 (616)	Technical Matters on Taxes, Claims Branch
	Technical Division 2 (512½)	Counter Avoidance and Evasion, Technical Matters on International Taxation
	Oil Taxation (29)	Administration of PRT etc.
	Solicitor's Office (172½)	Comprehensive legal service to the department
	Solicitor (Scotland) (21)	
Chief Valuer	Valuation Office (England & Wales) (5950½)	Valuation of land and property for tax purposes, valuations for rating; valuation services to other Government departments, local authorities and other bodies
	Valuation Office (Scotland) (221½)	As for England and Wales, *except* no rating work
Private Office (4)		

Note: 1. Figures in brackets are staff in post at May 1985.

5. The Board of Inland Revenue is responsible to Treasury Ministers, and they in turn to Parliament, for policy and legislation and the general tenor of the administration of the tax system. But on a day to day basis the care and management of the Revenue taxes, and in particular the settlement of individual tax liabilities, are entrusted solely to the Board.

6. The Board is the top tier of management in the Inland Revenue and comprises the Chairman, two Deputy Chairmen, two Directors General and the Chief Valuer who cover all aspects of policy, operations and support services. For historical reasons, the Head of the International Policy Division is also a member of the Board.

7. Figure 1 gives the organisation of the Inland Revenue. It shows the Board members and the Divisions which report to them together with their responsibilities. All told there are 21 separate Divisions. Each Division is managed at about Under Secretary level by a Director or Head of Division. Of particular interest is the fact that the bulk of the Department's staff who work in the local tax and collection offices (about 57,000 out of a total workforce of some 70,000) report to a single Director through a regional structure. Some Divisions are very small carrying out only policy work while others have a mix of responsibilities.

THE SMS RETURNS

8. Turning now to the SMS, the objectives set for it, as part of our FMI plans, were that it should allow the Board:

a. to decide priorities and objectives;
b. to allocate targets and responsibilities accordingly;
c. to measure performance against target;
d. to monitor costs; and
e. to reveal areas where change is or may become necessary.

9. At the heart of the SMS is an annual return from each Divisional Head. Since we started the SMS, the format of the returns has developed and now contains the following:

a. A clear, concise statement of the Division's aims and responsibilities.
b. A current organisation chart, showing the allocation of responsibilities at the next one or two tiers of management.
c. A summary of manpower used over the previous year by each organisational unit within the Division and the estimated needs for the coming year.
d. A summary of the issues facing the Division or the main features of its achievements and plans, together with any suggestions for efficiency reviews.
e. A detailed return giving the work done by the Division over the past financial year, progress during the current one and plans for the next. This return also shows the associated manpower resources.

10. Divisions have a fairly free hand in how they complete this last return. They classify their work and the manpower needed to carry it out in the way which is easiest and most suitable for them. What we have been looking for specifically are targets. For the operational tasks these may be performance indicators such as the accuracy rates of our clerical staff in local tax offices or the coverage rates for our accounts investigators. In Head Office they are more usually expressed in terms of the completion of specific projects.

11. As an illustration, parts of the detailed return from our Operations Division, which is responsible for the work of the local tax and collection offices, are shown in Figure 2. The information presented covers:

- the work of their operational units in terms of what needs to be done to run the tax system for different types of cases (the compliant and non-compliant taxpayer);
- the responsibilities of their Head Office Units and associated resources; and
- the functions and specific tasks carried out by these units at Head Office, much of which is concerned with the planning for and the implementation of change in the local offices.

THE REVIEW PROCESS

12. Having considered briefly the format of the SMS returns, we now come to the review process itself. So far, apart from a small pilot run early in 1983, there have been two annual exercises (SMS 1983 and SMS 1984).[4] The timetable is dictated by the annual cycle of Head Office work which to a large extent revolves around the preparation of the Chancellor of the Exchequer's Budget and the ensuing legislation. Since the preparation of the returns is a time-consuming job, the work on it is timed to fall during the early autumn, after the completion of the legislation which gives effect to the Budget of the current year, and before work on the coming year's Budget and Finance Bill gathers pace.

13. The review process takes the following form.

a. Each round starts in July with a session by the Board to set the scene. Divisional Heads are asked to provide a brief note on what they see as the main issues in their area of responsibility. This enables the Board to set the framework for the coming round and to identify anything which should be given priority.
b. Divisions prepare their returns during September and October.
c. Finance Division then collates them for the Board. In doing this the returns are scrutinised critically and suggestions are made on how individual returns can be improved.
d. In parallel the Deputy Chairmen and Directors General have meetings with their Divisional Heads to identify what issues should be raised at the review.

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[4] Senior Management System 1983 and Senior Management System 1984, the Reference Room of the Inland Revenue Library, Room 8 New Wing, Somerset House, The Strand, London WC2 1LRB.

Figure 2 – A detailed SMS return

SMS 1984

5A. DETAILED RETURN (NON POLICY UNITS) FOR: OPERATIONS DIVISION M4: OPERATIONAL ASPECTS DECEMBER 1984

1	2	3	4	5	6	7 MANPOWER				
WORK AREA	TASK/OBJECTIVE	OTHER DIVNS DEPTS	1983-84 ACHIEVEMENTS	1984-85 PROGRESS	1985-86 PLANS	Grade	Staff in post		Estimates	
							Apr83	Apr84	Apr85	Apr86
2. OPERATION OF SYSTEM ON NON-COMPLIANT TAX-PAYERS										
i. Investigation Work	To maintain cost effective coverage in the investigation of companies and other concerns and to deal with other investigation cases as necessary. (Performance measured by: a. Number and type of cases settled. b. Yield.)		a. The targets for both Sch D and Company A/cs investigation were achieved: Companies 1.5% Sch D 3.0% b. No targets are set for the yield of District investigation but the new MIS revealed that in 1983-84 the overall cost/yield ratio was 1:6. This can now be analysed:	The targets set are: Sch D 3.0% Company 1.2% The company target will be achieved. There may be a small shortfall on the Sch D target.	To maintain an acceptable level of coverage whilst improving the quality of the work done. Targets will be set in Feb/Mar 1985.	Man/ Tech	329	369	369	394
						Insp	1122	1177	1177	1202
						Trnee	75	140	140	140

SMS 1984

5B. DETAILED RETURN (NON POLICY UNITS) FOR: OPERATIONS DIVISION M4: HEAD OFFICE DECEMBER 1984

1	2	3	4	5	6	7 MANPOWER				
WORK AREA	TASK/OBJECTIVE	OTHER DIVNS DEPTS	1983-84 ACHIEVEMENTS	1984-85 PROGRESS	1985-86 PLANS	Grade	Staff in post		Estimates	
							Apr83	Apr84	Apr85	Apr86
1. District Procedures (other than PAYE) and Parliamentary Correspondence (M4/1)	1. To handle Parliamentary correspondence in matters of settled policy by providing the appropriate drafts 2. To provide the draft of the Chairman's report to the Parliamentary Commissioner on cases of this type. 3. To provide advice on District procedures (other than PAYE) and to devise/amend procedures to reflect changes in legislation; organisation or to improve efficiency. 4. To develop the CODA user requirement and clerical procedures. 5. To handle District submissions, suggestions and internal and external correspondence in this subject area.					Man	1	1	1	1
						Parliamentary Correspondence				
						Man/ Tech	4	4	3	3
						Exec	8	7	6	6
						District Procedures and Coda				
						Man/ Tech	7½	7½	12½	12½
						Insp	2	2	5	5
						TOHG	2	2	3	3
						TO/ CA	1	1	1	1

SMS 1984

5C. DETAILED RETURN (NON POLICY UNITS) FOR: OPERATIONS DIVISION M4: HEAD OFFICE FUNCTIONS DECEMBER 1984

1	2	3	4	5	6	7 MANPOWER				
WORK AREA	TASK/OBJECTIVE	OTHER DIVNS DEPTS	1983-84 ACHIEVEMENTS	1984-85 PROGRESS	1985-86 PLANS	Grade	Staff in post		Estimates	
							Apr83	Apr84	Apr85	Apr86
1. LINE MANAGEMENT AND SUPPORT FUNCTION a. Planning, directing and monitoring work standards and performance Taxes Clerical (M4/7) Taxes Technical (M4/2) Collection (M4/7) PAYE Audit (M4/7)	i. To analyse national and regional performance via the Management Information System. ii. To enable the Director of Operations to take the necessary management action in response to that performance. iii. To plan and direct the management of work to achieve the most efficient and effective use of resources.		Taxes Clerical The MIS in Taxes commenced with the quarterly reports from Districts on Form 384. Performance appraisals and appropriate action plans are passed to Regional Controllers and Director of Operations respectively to monitor achievements and to follow up where necessary.	Work is in hand aimed at producing a "diagnostic kit" which would give a rapid and comprehensive appraisal of District performance based on 384 reports, principally for the benefit of AGCs.	To further refine and develop MIS, especially taking into account COP and CODA and including the "diagnostic kit".					

e. The Board then holds a number of meetings, usually from late November through to early January, with the relevant Heads of Division in attendance. Besides the SMS document itself, there are notes from the Deputy Chairmen and Directors General and briefing from Finance Division who, in conjunction with some of the central units in Head Office, will have looked at all the returns to identify key topics or cross-Divisional issues which need to be raised, or points which should be put to a particular Head of Division.

f. Shortly after the final meeting the Board produces its own comprehensive report to the Financial Secretary, the Treasury Minister responsible for the Revenue. It details the outcome of the review, reports the results of any work which may have been initiated in the previous round and pin-points anything which may be giving cause for concern.

g. Thereafter the SMS document is published, subject only to the omission of confidential material (primarily in relation to tax policy work).

COSTS

14. The resource demands of the SMS are important in considering how effective it is for top and senior management. Although each Division usually has somebody at the middle management level to help in collecting the necessary information and preparing the returns, the Divisional Head still has to devote a considerable amount of his time early in the review process to discussing issues with his line managers. Then there are the preparation for and holding of several Board Meetings and any activity flowing from these. The first SMS round obviously made extra demands in setting up the system. But with the second round it is clear that the work involved in the SMS makes a large inroad into the time of senior management. As such the benefits from the SMS, both now and in the future, must be clearly seen as outweighing the perceived costs.

BENEFITS

15. The first and most obvious benefit of the SMS is that it provides a mechanism for producing a more comprehensive and systematic statement of what the Department has done in the past year and is trying to do over the next, than has been attempted hitherto. Actually producing the return is a useful discipline for managers. And the end result is an important source of information both for review and analysis by the central management services units and for helping Head Office staff know what is going on in Divisions other than their own.

16. Second, it has highlighted several issues which cut across Divisions and which might not have surfaced so readily for scrutiny by senior management. There are, of course, existing mechanisms for ensuring the proper co-ordination of the Department's work, not least of which is the geographical concentration of Head Office which makes day to day informal contact very easy to maintain. But in a period of rapid change and a growing workload at the centre a more formal and systematic approach, which the SMS provides, is helpful.

17. Third, the SMS provides a formal means of considering Deparmental targets, although its use in this way is limited at the moment. I return to the question of targeting later on in this article.

18. The fourth, and perhaps the most important benefit at the moment, is the way the SMS has been used by the Board as a means of identifying where change is or may become necessary, and in initiating the required reviews. One such review, which arose out of SMS 1983, developed a strategy for exploiting information technology over the coming decade.

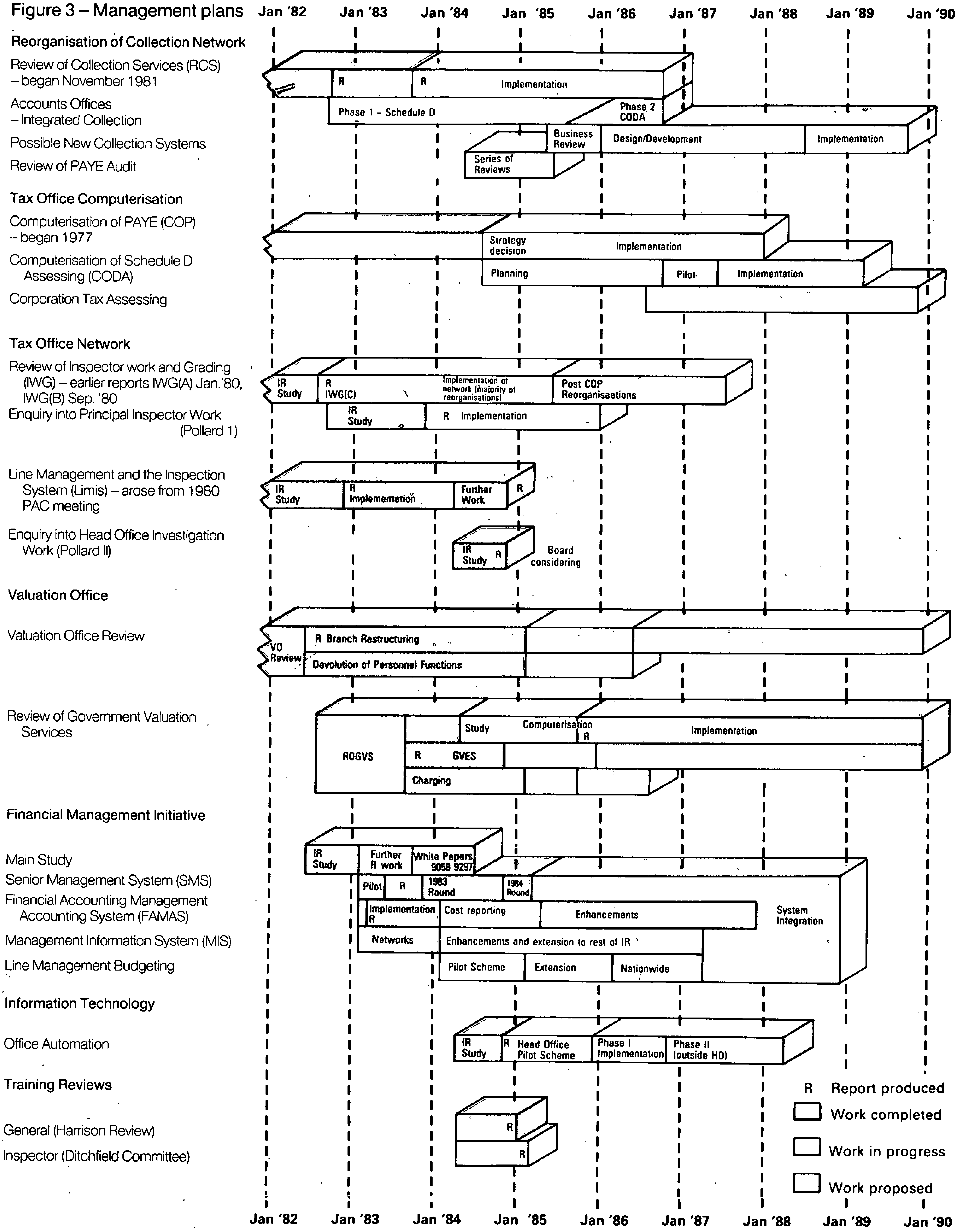
19. The process of change has figured prominently in both rounds of the SMS. At the conclusion of this year's review the Board decided that they needed to enunciate clearly, both for their own needs and managers, their medium term management strategy, which is set out in this year's SMS document and which:

- describes the Board's role vis-à-vis Ministers;
- outlines the background to the Board's medium term strategy;
- discusses briefly the relevance of decisions on tax policy to management issues;
- looks at programmes and objectives for applying information technology to the Department's work;
- deals with the far-reaching reorganisation of the local office network; describes developments and future plans for changes in the Department's management and operational methods, including the further development of management information systems;
- comments on a number of key factors in the Board's approach to personnel management and outlines developments in communicating with staff and the public; and
- touches on possible future developments in the tax system.

20. A summary, in diagrammatic form, of the timetable for the main changes which the Department faces over the next few years is reproduced at Figure 3. These initiatives all tend in the same direction, that is, of a Department which:

- meets its statutory responsibility for the care and management of the taxes it administers; for establishing the correct amount of tax and ensuring that it is paid;
- meets its statutory responsibility for the valuation services;
- is able to respond quickly and flexibly to changing policy requirements;
- is able to use efficiently whatever resources of manpower and money are invested in it by the Government; and, where the requirement is to reduce manpower, to do so by planned reductions in workloads and improvements in efficiency, rather than arbitrary cuts;
- strengthens the accountability, but also the freedom of action, of line managers on the basis of bet-

Figure 3 – Management plans



ter management information;
- provides up to date facilities for the staff who do the work; and
- arguably most important, provides a better service to the public.

21. Although not one of the original objectives of the SMS, one final benefit of the SMS this year has been the opportunity it has given the Board for communicating its strategy to staff who undoubtedly on occasion find all the change that is going on somewhat confusing. A paper setting out the strategy was circulated to all staff following this year's SMS round. Now with the publication of the SMS document this June, the public, or rather those with a particular interest in the management of the Revenue who are likely to buy it, have the opportunity to see a statement of the strategy and a comprehensive outline of the changes planned over the next few years.

PROBLEMS

22. As might be expected, since it has only been running for a couple of years, there are a number of problems with the SMS. Some are just teething difficulties, which have now to a certain extent been overcome, a couple are more fundamental, while others should be resolved as our FMI plans as a whole come to fruition. I will concentrate to begin with on the latter before moving on to consider possible lines of development which should overcome the more fundamental problems and which could make the SMS as a whole a more effective management tool.

FMI DEVELOPMENTS

23. As already mentioned, our FMI plans cover, besides the SMS, the development of better management and financial information systems at all levels of management and a new process of budgeting and control.

24. In the Revenue, what we call our management information systems (MIS) are designed to help operational managers assess more easily:
- the state and quality of the work;
- progress against specified targets;
- how efficiently and effectively staff resources are deployed.

25. We have made good progress in a number of areas of the Department's work. As an example, we now have an effective MIS for Inspectors who work in tax offices, largely on the technical scrutiny of business accounts and their detailed investigation. This has taken a number of years to develop and pre-dates the FMI. Amongst other things, this MIS enables management to monitor adjustments to taxable profits arising from the scrutiny of accounts by Inspectors and also the additional yield coming from the investigation of selected accounts as part of the compliance work. The Department sets yearly targets for the percentage of accounts which are chosen for detailed investigation. In conjunction with what we call our technical resources allocation guide, this information helps Head Office, regional and local management plan the resource levels for each activity and monitor the relative effectiveness of the work.

26. For the rest of the work handled by our local tax, collection and valuation offices MISs are now in operation, either based on previous systems or totally new developments. As management gains experience in using the MISs, then these will, of course, be developed further. We already know that some enhancements will be necessary to meet properly the objectives set in paragraph 24. For example, it is difficult to capture accurately and cost effectively all the information on the output of our clerical staff in tax offices, who operate the manual PAYE system. Computerisation together with a major clerical work measurement exercise, which is now in progress, should make further development possible. Another problem is the use of operational targets which is neither as easy nor as simple as it might appear at first blush. We already have a number of targets; for example, the coverage of accounts for investigation work, the accuracy rates for the main activities of the clerical staff in tax offices, and the annual clearance of cases by the professional valuation staff. Work is in hand to extend the range of targets used in the Department but care must be taken to ensure that appropriate indicators are chosen which encourage good practice and that the information on which each indicator is based is reliable.

27. Elsewhere in the Department (e.g. the Capital Taxes Office), we have developed or are developing operational MISs. The end result of all this effort should make it easier for Divisional Heads to assess the performance of the operational units for which they are responsible and to set targets and objectives accordingly. In turn with the incorporation of more and better summary information on performance and targets into the SMS than we currently have, it should provide the Board with a more effective means for reviewing and planning the operational work of the Department.

28. The other FMI development is the change in the Department's method of financial control. The current method of control rests on a number of Head Office units with responsibility for a particular resource (e.g. manpower, office machinery, accommodation), for estimating the demand for it, and monitoring and authorising expenditure on it. There is some delegation of the authority to spend to line managers but only within certain limits for specific resources. The proposals for a new budgetary control system will be to place responsibility for budgeting and controlling expenditure within the line management structure, where decisions about how resources are consumed are taken. Basically the current controls are on the acquisition of resources rather than their consumption. These proposals will give line managers more flexibility to make choices within the overall budget between different forms of expenditure with a view to getting the job done more efficiently.

29. A necessary prerequisite for this new form of control is an effective financial information system for re-

porting costs. Before April 1984 we had a wholly manual system for reporting both the running costs of the Department and for producing a Departmental analysis of revenue (although most of the revenue is processed through the computers at the two large Accounts Offices to which payments of tax are made). It did not allow us in any easy way to monitor the Divisional costs. From April 1984, we have been operating a computerised financial information system which enables us to track the expenditure of some 1500 office cost centres and 600 other cost centres. In addition we have been piloting in a small number of tax offices the proposals for the new budgetary control system, which we call line management budgeting. The pilot which ran during 1984/85 demonstrated:

- the support of local managers who feel the benefits more than outweigh the additional effort required of them;
- operational benefits (for example, flexibility to employ casuals to suit local requirements);
- greater choice and speedier service for offices in obtaining materials and supplies; and
- improved morale in the offices concerned (both management and staff) who are being given more control over their own affairs.

The pilot was extended to a further 100 offices from April of this year, and if it continues to be a success, then we will in due course introduce line management budgeting to all parts of the Department.

30. So far the SMS has not provided a mechanism for budgeting and resource allocation because of the financial control arrangements which still apply, even though the question of resources looms large in many of the Board meetings on the SMS. But line management budgeting will have a radical impact on the role and responsibilities of senior managers, who for the first time will have Divisional budgets to operate, covering all their costs and comprising the aggregate of their line managers' budgets. Although we have not as yet worked out fully the forum and the process by which Divisional budgets should be reviewed and agreed, it is clear that there must be some form of integration with the SMS which in turn must undergo some development. First, Divisional budgets will have to be considered about the same time as the SMS review takes place. And second, any budget needs to be firmly linked to the planned activities and targets, which at the moment are set out in detail in the SMS.

31. Given this integration then it should prove easier to determine priorities, judge competing claims for resources and ensure that budget bids can be justified based on past performance and future plans. Obviously it is important to get the balance right in any review. For the smaller Policy Divisions, what is more important is the work that they are doing and the impact this might have on the Department as a whole. Of less significance is the cost of the resources they consume. For the operational units costs will, of course, figure prominently in any review by top and senior managers.

32. So as envisaged in our original FMI plans, the developments in the management information systems for our operational work and the changes in the mechanism for resource control, should make the SMS a more effective and natural tool for the management of the Department. But from the experience gained in operating the SMS, further developments may be needed and I now discuss some of the possibilities.

FURTHER DEVELOPMENTS

33. The first major problem we have with the SMS is the volume and structure of the information it holds. Handling the amount of data, which the returns contain, is no easy matter, particularly as the SMS is a purely manual system. So a comprehensive update of the returns, except as part of the annual exercise, is not attempted. The returns therefore, while suitable for the review process itself, do not figure to any great extent in decision making during the subsequent year. Moreover, the returns are difficult to use for monitoring progress of work during the year. Yet cutting down on the information made available to senior managers as part of the review process, in order to ease the problem, would narrow the opportunity for critical scrutiny.

34. The free format that we have allowed so far in the presentation of the returns (the Operation Division's example is only one of a number) makes any attempt to use computers to handle the large volumes of data extremely difficult. In addition, the lack of standardisation in presenting the information across Divisions limits the scope for a more thorough analysis of it in order to draw conclusions of relevance to the Department as a whole.

35. Possible developments aimed at overcoming these problems might be:

a. to ask for the information to be presented in a more structured way so that general comments about plans and performance are separated from specific operational targets and other information which is susceptible to analysis or would be useful for tracking progress of the various Departmental projects and initiatives;
b. to make the information available to top management more specific to the particular management process concerned. At the moment we have the single major review process. With line management budgeting coming along one option could be to split the review into more specific sessions on budgeting and target setting, performance review and the identification of change. Also it might be an idea to separate, at least for some of the processes, the Head Office work from that of the operational units which have different interests;
c. to introduce senior line management systems. Although we do have our operational MISs, it could be argued that senior managers should have some system to support the other parts of their work. Such systems would, of course, feed the SMS but the advantage would be that they could be made more specific to the day to day needs of the senior

[continued on p. 386]

UNITED KINGDOM:

A New Approach by the Courts after Furniss

By J.F. Avery Jones

In 1935 when the Courts in the United Kingdom were deciding the *Duke of Westminster*[1] case which was the foundation of the formalistic approach in tax matters, the United States Supreme Court decided *Gregory* v. *Helvering*[2] which was the foundation of their "business purpose" approach. History seemed to be repeating itself in 1984 when the United Kingdom Courts moved towards the United States approach at the same time as the Canadian, Austrialian and New Zealand Courts moved in the opposite direction. The important United Kingdom decision was that of the House of Lords in *Furniss* v. *Dawson.*[3]

The facts can be simplified to illustrate the decision by looking at a taxpayer who owns all the shares in Company A which he wants to sell without paying capital gains tax. He transfers his shares to Company B which issues its own shares to the taxpayer in exchange. Company B then sells the shares in Company A to the outside purchaser. It should be noted that, in Furniss, there is no doubt that the transactions were real ones and Company B did become the owner of the shares in Company A, so that the case was not concerned with sham. The tax effect of these transactions at the time was, according to the statute, that the gain inherent in the Company A shares was transferred to the shares in Company B so that the taxpayer achieved his objective of deferring, though not avoiding, his capital gain. Company B was treated as acquiring the shares in Company A at their market value so that there was no gain when they were sold. The question in the case was whether the scheme was successful, as it appeared to be according to the legislation.

If one applied the law as understood by the *Duke of Westminster* case of 1935 there is no doubt that the taxpayer would have succeeded. The Courts had in the last few years been taking a more robust view of tax avoidance, in cases very different from this one, involving highly artificial circular transactions which left the taxpayer in exactly the same position as he started except for some hoped-for tax benefit. This approach had been extended to cases where the taxpayer ended up in the same economic position as he started even though his legal position was different. However, there seemed no logical reason why this approach should be adopted in a case such as this one where the taxpayer ends up in a completely different position, with the proceeds of sale inside Company B instead of in his pocket. This is exactly what was decided at the first three hearings, although achieving this result gave the courts some difficulty in view of remarks made by the House of Lords in the earlier cases. Where there were enduring legal consequences, such as the money ending up in a different place, the new approach seemed inapplicable. But the House of Lords decided otherwise. An extract from Lord Brightman's speech gives the essence of the new doctrine.

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> First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end. The composite transaction does, in the instant case; it achieved a sale of the shares in [Company A] by [the taxpayer to the purchaser]. . . . Secondly, there must be steps inserted which have no commercial (business) *purpose* apart from the avoidance of a liability to tax – not 'no business *effect*'. If these two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look to the end result.

This is an extremely wide approach and the real problem is to know how far it goes in practice: for example, what constitutes a composite transaction? Would it have been one in this case if the taxpayer had done the share exchange before finding a purchaser, or if the proposed purchase fell through but Company B later sold to another purchaser? Does it really mean *no* business purpose? What if there is some minor business purpose? How do you disregard a step? These are the uncertainties which we face in the United Kingdom at the moment.

Take the last of these questions. If one disregards the transfer to Company B in order to tax the taxpayer one actually has to write in a step which did not actually happen, that of the taxpayer putting the money into Company B as a subscription for new shares. In other words disregarding really involves rewriting. How far should this be taken? In a recent case, transactions actually done for cash were treated as exchanges of shares, the opposite of this case.[4] Some transactions do not lend themselves to disregarding without even more consid-

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1. Duke of Westminster [1969] AC 1.
2. Gregory v. Helvering (U.S.A.) 69 F.2d 809.
3. Furniss v. Dawson [1984] STC 153.
4. Young v. Phillips [1984] STC 520.

erable rewriting. The transfer of a business from one company to a subsidiary followed by the sale of the subsidiary to another company is difficult to reconstruct. The first company did make a transfer to a subsidiary and that subsidiary is now a subsidiary of a different company. To tax the transfer as that of the sale of the business directly to the subsidiary of the purchasing company is to tax quite a different transaction.

The disregarding of steps inserted with *no* business purpose is similar to the earlier United States approach and it is interesting that the latest cases there now seem to be looking for the primary motive as not being tax avoidance. Many people think that there will be a similar shift of view in the United Kingdom.

The approach in the *Furniss* v. *Dawson* case has been rejected in Canada in *Stubart Investments Ltd.* v. *The Queen*[5] on the grounds that there should not be implied any judicial anti-avoidance doctrine when there is a general statutory anti-avoidance provisions in the same area. The same has occurred in Australia in *Oakey Abattoir Pty. Ltd.* v. *F.C. of T*[6] and in New Zealand in *Challenge Corporation Ltd.* v. *CIR*[7] for similar reasons, particularly in view of the wide anti-avoidance provisions applicable there. (It is interesting to note that the opposite view had been argued in one of the earlier cases, that in the absence of any general anti-avoidance provision in capital gains tax the courts should leave Parliament to deal with loopholes, but this argument did not succeed.) None of this reasoning is applicable in the United Kingdom in relation to capital gains tax where there are no anti-avoidance provisions, but it may prevail in relation to other taxes, such as capital transfer tax, which do have such provisions or in certain areas, such as the deduction of interest, where there is a specific anti-avoidance provision. Whether the doctrine applies to stamp duty which is a tax on documents rather than transactions is unclear.

A difficulty which has not yet been faced in the United Kingdom is that Parliament may have intended that the taxpayer should do some transaction for tax purposes because of the tax incentive offered. In Canada this problem was recognised as one of the reasons for the decision. The difficulty is a particularly acute one because of the prohibition in the U.K. on using Parliamentary reports by the courts as an aid to interpretation.

The legislature has been drafting statutes on the basis that such doctrine did not exist and so now have the worst of all worlds: detailed statutory provisions endeavouring to cover every eventuality coupled with a new attitude of the courts disregarding some of the facts.

Another objectionable feature of the change in attitude of the House of Lords is that it is declaratory of the law and therefore applies to transactions done earlier while this tax is still unsettled. There is no power in the U.K., as there is in the U.S., for court decisions to be prospective or for the Revenue to apply a decision with retrospective effect.

It is still too early to tell how far the Revenue will try to use the new doctrine and the situation is obviously one of great uncertainty, particularly affecting commercial transactions which are done in a tax-efficient way. There are usually several ways of achieving a result and the choice will be dictated by tax factors. Often there will be steps inserted for tax purposes which therefore come within the doctrine. Equally the Revenue cannot press the doctrine to its logical conclusion that every transaction must be done in such a way as to pay the maximum amount of tax. The Revenue are therefore in a strong position to decide how far to use it. At present head office approval is required before taking the point in an appeal. So far only a very few transactions have been declared free of attack, and the act of making such a declaration is nearly as objectionable as the Revenue having the power to decide the amount of tax. The position is hardly one which would have appealed to Adam Smith: "the certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe from the experience of all nations, is not near so great an evil as a very small degree of uncertainty."

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[5] Stubart Investments Ltd. v. The Queen (Canada) [1984] CTC 294.

[6] Oakey Abattoir Pty Ltd. v. F.C. of T. (Australia) 84 ATC 4718.

[7] Challenge Corporation Ltd. v. CIR (New Zealand) [1984] 6 NZTC 61867.

[continued from p. 362]

19. Time limits for claims for credit

So far as concerns claiming relief for foreign tax against U.K. tax the normal rule is that a claim in respect of any income, must be made not later than six years from the end of the chargeable period for which the income is chargeable to U.K. tax. However where such credit has been rendered insufficient by reason of an adjustment to the other country's tax the time limit for a claim to additional credit is six years from the time when the adjustment was made – Section 512 ICTA 1970.

20. Status of these notes

These notes are for guidance only. They express the Inland Revenue's view of the law but they have no legal force and they do not affect any rights of appeal on points concerning a taxpayer's liability. Similarly any description in these notes of Inland Revenue approaches to the problem of transfer pricing or practices in dealing with this problem are not to be taken as limiting the Department to such approaches or practices in any particular case.

UNITED KINGDOM:

Dual Resident Companies – Uses and Abuses

By D.J. Murby

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INTRODUCTION

On 15 November 1984 the Inland Revenue published a Consultative Document entitled *Taxation of International Business – Dual Resident Companies* as part of the Government's continuing review of the taxation of international business.

The government considered that legislation was needed to protect the Exchequer and to reduce the distortion in the patterns of multi-national finance which in their view resulted from the use of dual resident companies. The proposal was to solve the matter either:

1. by denying or restricting the deduction for interest paid by the dual resident; or
2. by restricting group relief.

The government's intention was to introduce provisions in the Finance Bill 1985 establishing new rules applicable to accounting periods commencing on or after 1 April 1985.

It is understood that a substantial number of representations were made to the Inland Revenue in response to the Consultative Document. In the light of these representations the Chancellor of the Exchequer concluded that it would not be appropriate to introduce legislation in 1985. He stated that he had asked the Inland Revenue to keep the matter under close review, and if there is evidence of growing exploitation at the Exchequer's expense he will reconsider the possibility of remedial legislation.

The review process mentioned above has been commenced. The U.S. Internal Revenue Service is asking for relevant information from U.S. based multinationals. This data is being obtained at the specific request of, and on behalf of, the U.K. Revenue. Interested parties can expect this process to continue.

THE NATURE OF A DUAL RESIDENT COMPANY

A "dual resident company" is simply a company organised under the laws of one jurisdiction which is subject to taxation in two jurisdictions. The best known example, and one that is frequently used as a vehicle to make acquisitions, is a company incorporated in one of the United States which is centrally managed and controlled, and therefore resident in the United Kingdom. The State which provides the least onerous requirements as to reporting and state taxes is the State of Delaware and it is usual to find dual resident companies incorporated in this State and hence the jargon a "Delaware link company".

Under the old 1945 Double Tax Convention between the United Kingdom and U.S.A a company incorporated in one of the United States which was managed and controlled in the United Kingdom was deemed to be resident in the United States. When the new treaty was negotiated there were no provisions to determine one particular country of residence for a company which could be regarded as resident in both jurisdictions and, indeed, the treaty specifically refers to this strange animal in Article 1(2) as follows:

> A corporation which is both a resident of the United Kingdom within the meaning of paragraph (1)(a)(ii) of Article 4 (Fiscal Residence), and a resident of the United States within the meaning of paragraph (1)(b)(ii) of Article 4 shall not be entitled to claim any relief or exemption from tax provided by this Convention except that such corporation may claim the benefits of paragraph (2) of Article 8 (Shipping and Air Transport), of Article 23 (Elimination of double taxation) with respect to paragraph (1)(c) thereof and the petroleum revenue tax referred to in paragraph (2)(b) of Article 2 (Taxes covered), of Article 24 (Non-discrimination) and of Article 28 (Entry into force) and the provisions of paragraph (7) of Article 11 (Interest) shall apply to it.

In view of the fact that other treaties entered into by the United Kingdom provide the mechanism for determining fiscal residence of companies, it is not clear why this alternative was not adopted in the new U.S./U.K. treaty. It would be interesting if either authority were to give an explanation on this particular point.

The above restrictions are not particularly damaging to a dual resident company since domestic law in both countries provides for the exemption from corporate tax on intra-group dividends, elimination of withholding taxes on interest and royalties and of advance corporation tax on distributions by U.K. resident companies providing the appropriate percentage ownership is achieved. Furthermore, the shareholders of a dually resident company are entitled to the benefits specified under the terms of the treaty.

Nevertheless, the dual resident company is within the charge to tax in two jurisdictions and the complexities of the structure arise on managing the cross-border flows. Accordingly, it has always been assumed that the use of a dual resident company as an acquisition vehicle provides a mechanism for deferring tax liability in the country where the investment is located. Of course, such deferrals could still be obtained providing there is no repatriation of income to the parent company but without some of the attendant, albeit short term, advantages.

USES OF A DUAL RESIDENT COMPANY

Trading

In their Consultative Document the Inland Revenue recognised the existence of trading and profit seeking dual resident companies and proposed that where such companies happen to make losses they would be excluded from any new rules. They added the rider that the company had to be genuinely trading and provisions were to be introduced to prevent companies circumventing the new rules by carrying on a nominal trade.

The benefits of using a dual resident company to carry on a trading activity in another jurisdiction can be accomplished much more simply by having the activity carried on through a branch. Generally speaking, any profits or losses arising through a foreign branch are tax effective in the company's country of residence subject to double tax credit relief or an exemption under the terms of a double tax agreement.

The usual reason for setting up a branch or using a dual resident company to carry on a trading activity is to maximise the use of trading losses either during the start-up period or the period of reorganisation following an acquisition. The difficulties lie in reorganising the structure once the take-off has been achieved to eliminate the taxation by two jurisdictions. Unless a considerable period of "loss-making activity" is envisaged, e.g. exploration companies in the U.K. sector of the North Sea, it is unlikely that a dual resident company will be set up to operate as a genuine trading company.

The difficulties envisaged above would include potential recapture of loss relief, lapsing of losses and tax on capital gains on the transfers of assets. On incorporation of a foreign branch these problems are not usually insuperable and can generally speaking be accomplished with minimum tax cost. However, attempting to take the trading dual resident company outside the scope of one tax authority is a more daunting task. A company incorporated in one of the United States is always within the charge to United States Federal Tax. If the company is trading in the U.K. it would be necessary to make an out-bound transfer of the trade to a company incorporated outside of the United States. A transaction of this nature would require consent of the Internal Revenue Service under Section 367 Internal Revenue Code (hereinafter "IRC") and would almost certainly result in the toll charge of recapturing the loss relief taken on the consolidated return.

A U.K. group which has a dual resident company trading in the United States could achieve the desired result of isolating profits from the U.K. fiscal authorities in one of two ways:

1. by sale of the trade and assets to another company incorporated in the United States; or
2. emigration of the company from the United Kingdom.

Whilst Treasury consent to emigrate is likely to be obtained under Section 482 Taxes Act 1970[1] there may be other U.K. tax consequences arising, such as a charge under Section 278 Taxes Act 1970 on any gains on assets transferred tax free intra-group in the preceding six years.

Apart from certain special circumstances the genuinely trading dual resident company is likely to be a rare specimen. Although examples exist of companies being treated as dually resident in the U.K. and jurisdictions other than the United States it is suggested that determination of the place of effective management, as provided for under most treaties concluded by the United Kingdom, would eliminate this phenomenon.

THE INVESTMENT COMPANY

The main reason multinational groups use dual resident companies is as investment holding companies, appropriately capitalised, through which acquisitions are made either in the U.K. or the U.S.A.

While the dual resident company is subject to tax in both jurisdictions on its world-wide profits, its tax losses can be used in both the countries in which it is resident. Therefore, the object is to generate tax losses without producing taxable income. Depending on whether the investment is an inward or outward investment from the parent company's viewpoint, the structure to be used is slightly different.

However, before examining the structure in detail it is necessary to ensure that the company, incorporated in one of the United States, is in fact resident in the U.K. by virtue of central management and control being exercised there. Despite Inland Revenue pronouncements in statements of practice and other consultative documents the statute and case law on the subject of residence has not changed in recent years. The statutory definition, such as it is, is found in Section 482(7) Tax Act 1970 and the most quoted case law is De Beers Consolidated Mines v. Howe (5 TC 198) and Bullock v. Unit Construction Company (38 TC 712).

In July 1983 the Revenue issued a Statement of Practice on company residence (SP 6/83) in which they set out their approach to the determination of the residence status of a company as follows:

1. they first try to ascertain whether the directors of the company in fact exercise central management and control;
2. if so, they seek to determine where the directors exercise this central management and control (which is not necessarily where they meet);

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[1] Income and Corporation Taxes Act 1970, commonly referred to as the "Taxes Act 1970".

3. in cases where the directors apparently do not exercise central management and control of the company, the Revenue then look to establish where and by whom it is exercised.

The place in which central management and control is exercised is wholly a question of fact. However, it is worthwhile quoting in full the concluding section of the Revenue's Statement of Practice since it will encourage vigilance by the multinational in ensuring that appropriate documentation supports the facts.

> In outlining factors relevant to the application of the case law test, this statement assumes that they exist for genuine commercial reasons. Where, however, as may happen, it appears that a major objective underlying the existence of certain factors is the obtaining of tax benefits from residence or non-residence, the Revenue examines the facts particularly closely in order to see whether there has been an attempt to create the appearance of central management and control in a particular place without the reality.
>
> The test examined in this statement is not always easy to apply in present day circumstances. The last relevant case was decided over 20 years ago and there have been many developments in communications since then, which in particular may enable a company to be controlled from a place far distant from where the day to day management is carried on. As the statement makes clear, while the general principle has been laid down by the courts, its application must depend on the precise facts.

The burden of proof of the situs of residence is on the taxpayer. The taxpayer must be able to produce evidence of the place where central management and control is exercised and the following action would be helpful in this regard.

a. The Board of Directors' meetings should always be held in the United Kingdom. The company's Bye Laws should specify that all meetings will be so held.

b. The principal officers of the company should be U.K. residents.

c. Where all of the directors are not U.K. residents then a quorum for directors' meetings should include all U.K. resident directors.

d. A majority of the directors should be U.K. residents.

e. The Board of Directors must exercise effective management and control and not delegate such authority to anybody resident outside the United Kingdom.

f. The books of account of the company should be kept and maintained in the United Kingdom.

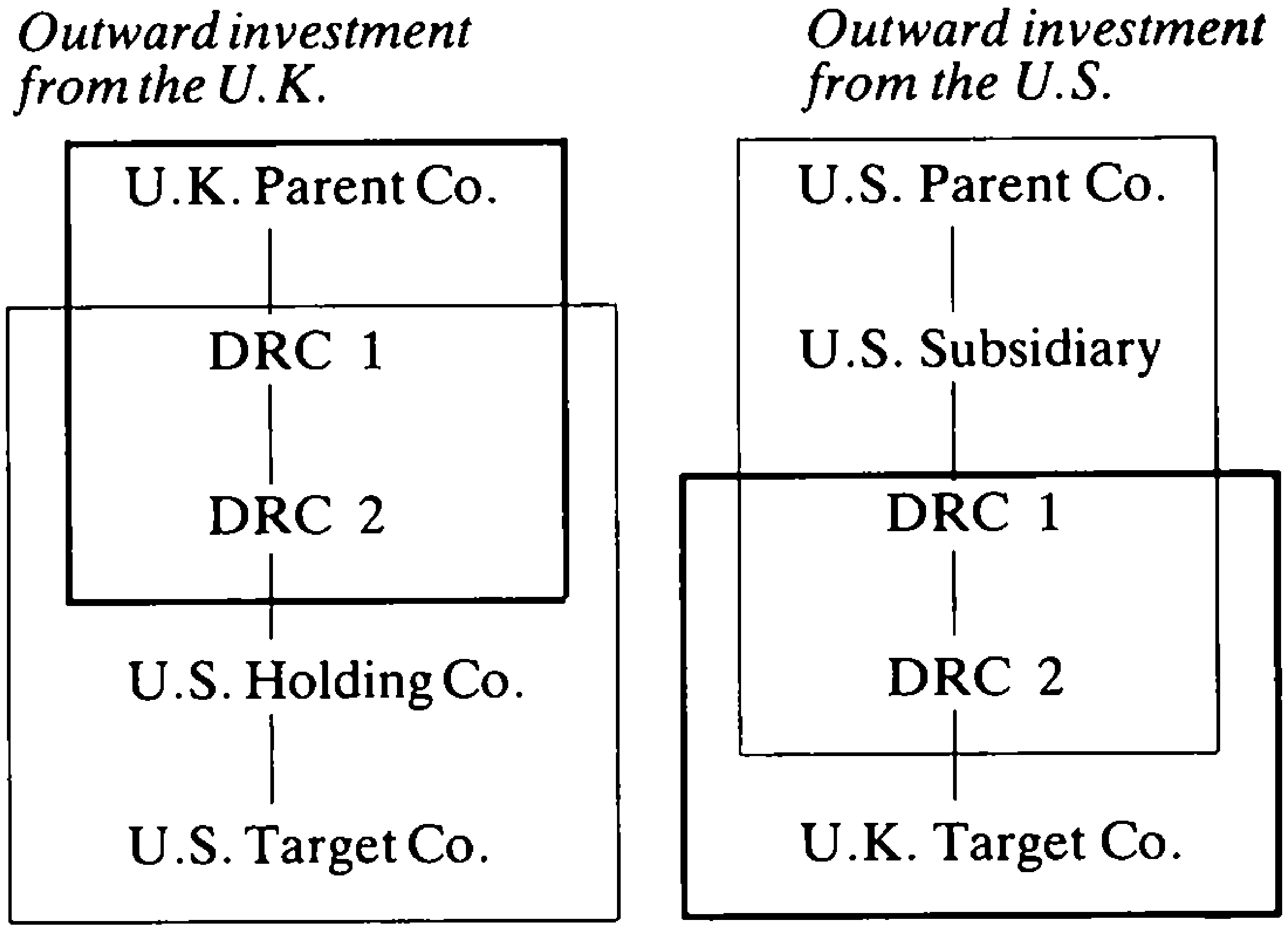
g. Minutes of the directors' meeting should be maintained specifying place held, board members attending and nature of business discussed and concluded.

h. Compliance with all U.K. business laws and practices.

Observance of the above rules should achieve the first step of establishing residence of the companies in the United Kingdom but this fact should be agreed with the U.K. Revenue as soon as possible. Normally, the first opportunity would be the filing of an election under Section 256 Taxes Act 1970 seeking permission to pay dividends intergroup without accounting for advance corporation tax. The U.K. Revenue must satisfy themselves that the company is resident in the U.K. before they can certify that the election is validly made. Accordingly acceptance of an election implies that the companies are regarded as resident by the Revenue.

STRUCTURE

The recommended structure in diagrammatic form is as follows



The thick-lined box denotes a group for U.K. tax purposes and the thin-lined box represents a consolidated group for U.S. tax purposes. In the above example, each company in the chain is owned as to 100% by its immediate parent, although this is not essential to the success of the arrangements. The minimum ownership requirement is 80% to fall within the U.S. consolidation and dividend exclusion rules, and 75% to fall within the U.K. group relief rules.

The objective is for DRC 1 to borrow the funds which the group wishes to use to make the acquisition of the Target Co., and for the group to take a tax deduction for the interest expense in arriving at its taxable profits in the U.K. and the U.S.

From the outset it is essential to be able to project, with reasonable accuracy, that there will be current taxable profits in the U.K. group and in the U.S. group to maximise benefits. Should this not be the case then any unused interest expense may be locked into DRC 1 from a U.K. tax viewpoint. Unused losses attributable to interest expense will carryover to future profits arising in the U.S. consolidated group; the position will have to be monitored to ensure that loss carryovei limits (currently 15 years) are not exceeded. To the extent that losses are not used currently there is an erosion of the anticipated benefit.

In order to obtain a deduction in the U.K. for the interest expense the company incurring the expense must be either a trading or investment company. As has already been pointed out, the trading dual resident company is a relatively rare species so it is essential to make the effort to ensure that the company is regarded as an investment company within the provisions of Section 304(5) Taxes Act 1970 as follows:

> . . . (an) "investment company" means any company whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom, . . .

There is a view that the company should have more than one investment to qualify as an investment company. However, this appears to be incorrect since the word "investments" would encompass the singular in accordance with the Interpretation Act. Nevertheless, it is recommended that other small investments are made by the DRC 1 so that it has regular income arising. These can be in the form of U.S. Treasury Bills, or some other similar "safe" investment. Otherwise it may be necessary to declare dividends from the Target Companies to demonstrate that the principal income of DRC 1 is derived from investments and satisfy the statutory definition; this may not be tax efficient.

Deduction for the interest expense is obtained in the U.K. under Section 248 Taxes Act 1970. A U.K. resident company is required to withhold tax from interest paid to a non-resident subject to the terms of the relevant tax treaty. Thus, while there is no technical reason for the borrowing to be from a United Kingdom source, companies may consider that it would be prudent to borrow from a bank carrying on a bona fide banking business in the U.K. to avoid the requirement to withhold tax.

There are several reasons for this suggestion. The first general observation is that in the current climate any dual resident structure will be examined critically by the U.K. Revenue Authorities and it is sensible to eliminate potential areas of attack where this is practical. In their Consultative Document, the Inland Revenue expressed the view that little or no tax was payable on the interest paid by dual resident companies in the hands of the recipients because the financing was provided either by another member in the multinational group, or a third party, both of whom were resident outside the United Kingdom. If the group is borrowing from a U.K. source this observation by the U.K. Revenue would not be relevant in the particular case. Furthermore, if the borrowing is from a third party source, then there would be no possible line of attack in the Revenue attempting to treat the interest expense as a distribution within the provisions of Section 233 Taxes Act 1970 and consequently not a deduction in arriving at taxable profits. Although the provisions of Article 11 of the U.K./U.S.A. treaty override the specific provisions of Section 233 Taxes Act 1970, there is still an opportunity to deny a reduction of the withholding tax rate to zero on the quantum of interest that is regarded as "excessive" under Article 11(5). The U.K. Revenue believe that the wording is so wide that it enables them to impute thin capitalisation rules which are not contained in the domestic legislation. The Revenue's argument, based on statistical evidence derived from the capital structure of companies quoted on the U.K. Stock Exchange, is that the debt : equity ratio of a company should approximate 1 : 1. In practice however, the Revenue would probably accept a debt : equity ratio in the order of 3 or 4 : 1 which seems to be generally accepted by the Oil Taxation Office.

Most commentators do not believe that the anti-avoidance provisions contained in Section 38 Finance Act 1976 can apply to these types of transactions under which the interest is paid, since the sole or main benefit is not the obtaining of a reduction in tax liabilities. The main benefit derived by the company is the use of the funds to make its acquisition and not the obtaining of an interest expense. However, it is conceivable that the Revenue would attempt to take the point particularly if they believed that this was a circular transaction where no new money was borrowed by the group as a whole.

There is also the interesting possibility of the Revenue attempting to apply the Ramsay and/or Furniss v. Dawson argument in the above circumstances.[2]

Accordingly, genuine third party borrowing not only removes a potential source of attack but also, if the lender is a U.K. resident, it circumvents the political argument that no U.K. tax is collected on the interest income.

In order to put itself in the best light from a tax viewpoint the multinational should not overlook other very relevant matters in connection with source of funding. It must take into account the economic exchange risk and the mechanisms of matching and/or covering. Other real economic costs of the rate of interest, fixed or floating, and the ability to swap are all relevant to the evaluation. In addition, the accounting implications and the tax treatment of the exchange gains or losses can have an important impact on earnings per share.

There appear to be few problems from a United States tax viewpoint on the deductibility of the interest under any anti-avoidance provisions, but there is a much more fundamental problem concerning the allocation of the interest expense within the provisions of Regulation 861-8. In broad terms, the Regulation seeks to allocate interest expense to the income of a company using one of several alternatives. The problem to overcome is an allocation of the interest expense to the foreign-source income of the United States consolidated group on an overall basis in circumstances such that excess foreign tax credits are generated which cannot be used currently.

In the absence of any planning the allocation of the interest expense to foreign-source income reduces the taxable income, increases the effective rate of foreign tax on that income and excess credits are created considerably reducing the benefit of the interest deduction. Therefore, from the outset action must be taken to organise matters so that one of the other bases of allocation of the interest expense would be applicable. These

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[2] See for a discussion of *Furniss v. Dawson* the article by John F. Avery Jones in this issue. See for the *Ramsay* case 21 *European Taxation* 4 (1981) at 135.

are: specific property method, asset method and optional gross income methods.

The specific planning depends on the precise facts and circumstances of each particular case and it can involve a very complex structure. On of the "simplest" mechanisms, and shown in the structure diagram above, is to ensure that the company incurring the interest expense receives at least 21% of its gross income from U.S. sources such that the whole of the interest is allocable to domestic rather than foreign source income. Although this sounds simple it is not that easy to achieve without considerable erosion of the benefits. However, if President Reagan's proposals ever become law the planning required will change dramatically since foreign tax credits would be calculated on a per country, as opposed to an overall, basis, allocation of interest expense will be on a consolidated basis, and 80/20 companies would be abolished.[3]

CAPITAL DUTY

One other point that is worth mentioning while dealing with the structures to be established is the cost of the capital duty at the rate of 1% ad valorem on the equity of the dual resident companies. This duty can be avoided completely by using either of the following methods:

i. The most commonly used technique to avoid capital duty is to ensure that there is a restriction placed on the disposal of shares in the company by the shareholders. It is necessary to ensure that the Bye Laws of the company contain a positive and direct prohibition against transfer of shares. It is not sufficient for the directors of the company to be able to decline to register a transfer. Therefore, the Bye Laws should provide that no transfer may be made without prior authorisation of the directors, who may in fact decline to authorise any transfer without giving any reason. The restriction placed on the disposition of shares is a requirement that cannot be changed in the future; otherwise a liability to capital duty would result under Schedule 19 para. 2(1)(a) Finance Act 1973.

ii. The alternative mechanism is to use an unlimited liability company. Providing the company incorporated in the United States does not have a limited liability equal to its share capital then it appears that it would not be regarded as a capital company within the provisions of Section 48(1)(e) Finance Act 1973. However, some groups would not wish to have an unlimited liability company within their group because of the potential wider commercial implications.

SERVICING THE DEBT

The next step in the transaction is to determine the mechanism for servicing the debt and, where necessary, in amortising the debt. The objective is to achieve these ends without generating taxable income in either jurisdiction. Normally, one would select from a menu of methods suitable to the particular circumstances of each multinational group which will achieve the stated objectives. The alternatives would include, inter alia, the following:

i. From the United Kingdom viewpoint a payment would be made by the company(ies) receiving the benefit of the group relief to DRC 1. The U.K. receiving member can pay up to 100% of the loss surrendered without U.K. tax consequences to either the payor or recipient company (Section 258(4) Taxes Act 1970). DRC 1 would also receive a payment from the U.S. company within the U.S. consolidated group that was receiving the benefit of the loss under a tax sharing agreement. There may be an argument that the receipt from the U.S. group members is taxable income in the U.K. but presumably the surrendered amount of the loss would constitute the cost thus reducing the net gain to zero. The U.S. Revenue would probably treat the payments as a contribution to capital or a deemed distribution depending on which company makes the payments. (Rev.Proc. 80-18; Ltr.Rul. 8241009.) Although the position is not free from doubt it is unlikely that there will be any material U.S. tax cost.

ii. The DRC could borrow additional funds in order to finance the debt servicing costs and any amortisation. These additional borrowings could be either from third parties or intra-group. If the borrowings are intra-group then the issues already mentioned under the Section 233 Taxes Act 1970 and the thin capitalisation "rules" have to be taken into account. From a United Kingdom viewpoint upstream loans from a United States subsidiary would be an acceptable mechanism of funding particularly since the anti-avoidance proposals were not enacted in the controlled foreign companies rules introduced in 1984 which would have converted such loans into deemed dividend income. Furthermore, since the loan would be from a U.S. resident company to a dually resident company it could be at nil interest without any U.K. or U.S. tax consequences under the respective anti-avoidance transfer pricing provisions in Section 485 Tax Act 1970 and Section 482 IRC. However, such a mechanism may not be tax efficient in the United States if the loan was upstream from a U.K. subsidiary to a U.S. resident company since the provisions of Section 956 IRC would come into play. Any loan from a foreign company to a United States company within the controlled group is regarded as an investment in United States property if it is outstanding for more than 12 months and would constitute a dividend under U.S. rules. Deemed dividends under Section 956 IRC do have their uses in other circumstances but it would not generally be appropriate to use this

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[3] An 80/20 company is a U.S. company which derives more than 80% of its gross income from foreign sources during a 3-year period ending with the tax year preceding the declaration of dividends or interest paid. Such dividends distributed or interest paid is deemed not to be derived from U.S. source, and, if paid to non-residents, therefore not subject to the 30% withholding tax.

particular route as a financing mechanism for a dual resident company.

iii. Additional equity may be injected into the DRC by either the U.K. or U.S. parent company within the group. If the injection is from a U.S. parent company then quite often it would be in the form of a capital contribution rather than taking up further shares. The capital contribution would be treated as a non distributable capital reserve. Neither mechanism has a tax consequence in the U.S. or the U.K.

iv. The use of dividends as a mechanism of contributing cash to the dual resident company is not generally tax efficient since dividends received from one country are subject to tax in the other with relief being granted for underlying foreign tax credits. Any dividends paid by a United States company to another company in the U.S. consolidated group is excluded from taxable income. However, since the company is also within a charge to U.K. tax the dividend income would be assessable to U.K. corporate tax subject to relief for underlying U.S. taxes paid. Since the interest expense will have reduced the quantum of U.S. taxes payable then the effective rate of U.S. tax, using the Bowater principles,[4] would be correspondingly lower. Nevertheless, with the reduction of the U.K. corporate tax rate to 35% with effect from 1 April 1986 the U.S. effective rate of tax on distributed profits may still be sufficient to offset the U.K. liability. This position may well change should President Reagan's proposals be translated into a Tax Bill which is subsequently passed by Congress.

Any distribution by DRC 2 into DRC 1 would be treated as franked investment income in the U.K. and can be paid without accounting for advance corporation tax providing an appropriate election under Section 256 Taxes Act 1970 is in force. Any distribution by DRC 1 to a U.K. parent company would cause a U.S. withholding tax to be paid at the rate of 5% which would never be a creditable tax in the United Kingdom.

Although dividends may not be a tax efficient mechanism of funding the interest costs the structure must be able to accommodate dividends should they be necessary. That is why it is necessary to have two dual resident companies in the chain of ownership. DRC 2 isolates the foreign tax credits to be used in full.

CONCLUSION

This article has concentrated principally on the uses and some of the mechanics of operating dual resident companies. The abuses of dual resident companies have been referred to somewhat in passing. From the corporate sector's viewpoint the abuses appear to be lack of detailed forward planning so that they find themselves with additional problems that they should not have created by the use of dual resident companies within their international structure. For example, transferring loss-making trading activities from a United Kingdom incorporated and resident company into a dual resident company does not make a great deal of sense if there is an intention to divest parts of the business in a subsequent rationalisation. Quite often, the tax consequences of transactions are not considered early enough to fit them into the commercial objectives of the company. Another abuse perpetrated by the corporate sector is that they use such arrangements because they think they are tax efficient without considering all of the other alternatives to achieve their objectives.

The abuse from the fiscal authorities' viewpoint is the mere existence of dual resident companies. It is quite clear that the U.K. Revenue would wish to abolish their use, on what appears to be moral grounds, that a corporation should not be entitled to a tax deduction for an expense against profits in two jurisdictions. It appears unlikely that U.K. domestic legislation will be changed in the future to remove the benefits of dual resident companies. It is conceivable, however, that the U.K. and the U.S. fiscal authorities may seek to renegotiate the double tax treaty between them to the effect that a company can only be fiscally resident in one jurisdiction. Presumably, they will have to overcome some of the other political drawbacks, such as unitary taxation, in the process.

There is no question that the use of a dual resident company can produce long term deferrals of current tax liabilities, even if not absolute savings, in the right circumstances. Any U.K. or U.S. based multinational considering acquisitions in the other jurisdiction should seriously consider the benefits which can be obtained through the use of such vehicles. The opportunity might be short-lived but that is all the more reason for taking it.

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[4] ● Bowater Paper Corporation Ltd. v. Murgatroyd [46 TC 37]. The Bowater case determined the method of calculating foreign tax credit available for offset against U.K. corporation tax. The case decided that the profits out of which the dividend was paid should be the profits as shown in the company's accounts (i.e. the distributable profits) and not the profits assessed to foreign tax.

U.K. Taxation and Currency Fluctuations

By Jill C. Pagan, Barrister

The United Kingdom, in common with most developed nations, has a tax system designed at a time before floating exchange rates became an everyday problem and which has not been adjusted to take account of the complexities that currency fluctuations give rise to in present day trading and investment transactions. Accordingly, right throughout the United Kingdom taxation provisions there are anomalies concerning the treatment of exchange gains and losses. Until there is a change in the law, established tax principles and statutory provisions will conflict with the commercial measurement of trading profit and investment return and the areas which need to be explored to resolve the conflict are themselves subject to uncertainties. It is always necessary to keep an eye open for tax fragmentation whereby a commercially matched currency transaction may be fragmented with the 'matching' not carrying through for tax purposes.

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THE CAPITAL/REVENUE DISTINCTION

The main problem area in the United Kingdom tax system is the capital/ revenue distinction which is central to the determination of trading profit and gives rise to tax fragmentation where one half of a commercially matched transaction might be classified as a revenue item and the currency gain chargeable to income or corporation tax, but the corresponding currency loss on the other half of the transaction be caught under the capital gains tax provisions and so produce a capital loss. Dependent upon the way the currencies fluctuate, the reverse may happen and the loss be a revenue item with the corresponding gain brought into charge as a capital gain. The latter situation may not be too serious for the taxpayer, as trading losses may be offset against other profits and capital gains are taxed at a lower rate of 30%. It is the first situation which can produce an extremely undesirable result for the taxpayer since the currency gain is taxed at full income rates and the currency loss is reflected at best as a capital loss which may not be of particular use.

There is an additional hazard where a non-revenue item is concerned. Transactions which might be thought to come within the capital gains tax legislation could be specifically excluded from the charge. For example a simple debt is not a chargeable asset in the hands of the original creditor and if a currency loss is suffered on repayment, no tax relief can be given. Equally a currency loss on repayment of a loan on fixed capital account does not give rise to an allowable loss for tax purposes to the debtor. It follows that currency gains on these loans do not give rise to a taxable gain in the hands of either the original creditor or the debtor, so the opportunity can arise for the taxpayer to use tax fragmentation in his favour. However this is not that easy to achieve; it is impossible to know in advance which way the currencies involved will fluctuate against each other and even if the loan transactions are flexible and can be rescheduled, the cost of rescheduling and obtaining fresh loan finance has to be taken into account when considering whether the crystallisation of a tax free currency gain is worthwhile.

FOREIGN CURRENCY BORROWINGS

The area which seems to cause the most frustration is the non-deductibility of foreign currency losses on repayment of long-term foreign currency finance which is fixed capital in nature. It is argued that as the U.K. tax system accepts that the cost of corporate finance should be allowed as a deduction in computing taxable profit (there are no general thin capitalisation rules and specific provisions allow the deduction of interest and the cost of obtaining loan finance) there can be no justification for denying a tax deduction for any currency loss on repayment of foreign currency loans and, conversely, allowing tax free currency gains should the particular currency have weakened against the pound at repayment date. The economic reality is that, broadly speaking, interest rates and exchange rates are related; a strong currency likely to appreciate will carry a low rate of interest, whereas a weak currency likely to depreciate will carry a higher rate of interest, although there are exceptions to this rule as the interest rate on U.S. dollar borrowings has shown of late. There is little sign that the government, perhaps mindful that the overall trend of the pound against foreign currencies has been downward and that there could be more allowable losses than taxable gains, will make the desired adjustments to the U.K. tax system in the immediate future. Taxpayers can only be aware of the tax trap and carefully evaluate in after-tax terms the true cost of foreign currency borrowings before reaching a decision.

THE MARINE MIDLAND CASE

The rapid fall of the pound Sterling against world currencies in the mid 1970s – the pound fell 50% against the Swiss franc and 30% against the U.S. dollar – concentrated taxation advisers' minds on the tax treatment of foreign currency borrowings, and in particular those long-term borrowings which would be fixed capital in character. While it was accepted that manufacturing companies would be caught in the tax trap with the massive currency losses not coming into account for tax purposes, the majority view was that those carrying on a matched foreign currency trade (e.g. banks) would not suffer from tax fragmentation in respect of long-term foreign currency borrowings used for normal banking business, such loans being subordinated to creditors in order to increase the capital base of the banks for limits of banking business purposes.

The basis of this view was that trading profits are to be ascertained by tests applied in ordinary business, the appropriate test being the profit as shown in the profit and loss account in accounts prepared in accordance with ordinary principles of commercial accounting (see *Sun Insurance Office v. Clark* (1912) 6 TC and BSC *Footwear Ltd. v. Ridgeway* (1971) 47 TC). The profit and loss account so prepared will only be departed from if there is material conflict between it and established tax principles (see *Willingale v. International Commercial Bank Ltd.* (1978) STC 75). In the case of a bank operating a matched foreign currency trade, which looked only to the interest turn on loans for profit, did not speculate in foreign currencies, never converted any of its foreign currency to sterling and kept separate books for each matched foreign currency trade which was carried on on a foreign currency base, put simplistically, the profit and loss account would reflect the matched position and would not be departed from as contrary to established U.K. tax principles as no currency gain (or loss) would be realised on the repayment of loans on revenue account to customers because there was no physical conversion of the foreign currency to sterling. The fact that the bank's long-term foreign currency borrowings might be fixed capital (which was disputed in any event) would be immaterial.

To the surprise of many, the U.K. Revenue – perhaps attracted by the particular nature of the foreign currency borrowings of the bank *Marine Midland* which made them one of the best candidates for classification of fixed capital borrowings ever to exist for bank borrowings – took the view that tax fragmentation would apply to banks carrying on a matched foreign currency trade in the manner set out above and persisted with that view to the highest court in the land. In the event their arguments were dismissed by the House of Lords with the words "the Revenue's contentions are fundamentally unsound". It has to be said that the House of Lords judgement is brief and does not cite one single case or statutory provision – perhaps a reflection of the U.K. tax system not having specifically addressed the existence of floating exchange rates. There was a hope that when this case (*Pattison v. Marine Midland Ltd.* (1984) STC 10) reached the House of Lords there would be a full discussion of the whole issue of fixed and circulating capital in relation to foreign currency borrowings so that some general guidance on this area would emerge; it was not to be as the case was decided on the primary issue of trading profit and the nature of long-term foreign currency borrowings put aside for another day. It is believed there are one or two cases on this issue at the start of the legal pipeline (at Commissioner level where confidentiality of a taxpayer's affairs is maintained) but it is likely to be some years before they reach the House of Lords.

However, at Court of Appeal level two useful pointers did emerge out of the *Marine Midland* case. Firstly, there are very strong dicta to the effect that although the U.K. levies a sterling tax which is to be assessed and paid in sterling, there is no requirement to actually compute the profits of a trade according to a sterling base. For example, a company which carries on a trade wholly in U.S. dollars, never converts those dollars to sterling, and keeps books of accounts in dollars, does not have to reflect in its profit for tax purposes notional currency gains and losses (measured against the rate of exchange to sterling at Balance Sheet date) on its assets and liabilities. It may, as indeed did *Marine Midland,* produce consolidated annual accounts in sterling but, in the words of the Master of the Rolls, Sir John Donaldson, "(this) would not preclude a company from drawing up a multi-currency profit and loss account providing an 'English translation', i.e. a twin account expressed in sterling". The House of Lords did not specifically address this point in their judgment, but there is nothing in it which is inconsistent with the dicta in the Court of Appeal and indeed it was quite obvious during the hearing of the case that their Lordships' House did not accept a need to compute profit only on a sterling base, if the facts showed a trade to be carried on with reference to a foreign currency base.

Secondly, *Marine Midland* does provide authority for the proposition that a currency gain or loss is not to be recognised for tax purposes until it is actually realised, and to be realised there must be actual physical conversion of the foreign currency. Mere book translation – which is simply the valuation of an asset of currency in terms of sterling at a particular date – produces only a notional and, therefore, unrealised gain or loss. It would, though, be incorrect to say that translation can never give rise to a taxable currency gain or loss; for example, where an accruals basis as opposed to a realisation basis is appropriate for tax purposes, then an element of translation as opposed to conversion is involved.

U.K. REVENUE STATEMENT OF PRACTICE

The complexity of the issues underlying the *Marine Midland* case is illustrated by the fact that it took nearly 14 months after the House of Lords' decision before the Revenue were able to issue a Statement of Practice (SP 3/85) on Exchange Rate Fluctuations.[1] Even then, SP 3/85 made history as being the first Provisional Statement of Practice to be issued and the final version will not be settled until the submissions of all interested parties on the provisional statement have been considered. What SP 3/85 does do is make an attempt to assist taxpayers and the Revenue to cut through the backlog of outstanding tax assessments which were waiting the outcome of the *Marine Midland* case by providing for taxpayers to settle back years on the basis of SP 3/85 if they so wish. What will happen here, of course, is that taxpayers to whom SP 3/85 is favourable will settle, whereas those to whom it is not will make representations and await the final version.

The Provisional Statement of Practice attempts to extend the principle of a commercially matched position on currency exposure to all trading transactions and not just to the narrow transactions of a financial trade which were at issue in *Marine Midland*. Herein perhaps lies the Achilles heel of SP 3/85. Financial traders by the very nature of their trade and by the fact that they are subject to a separate Accounting Standard would qualify for different tax treatment on currency exposure to other types of traders. If SP 3/85 had been restricted to financial and quasi-financial trades then, with one or two alterations, it might have provided a broadly satisfactory model. As it is, it gives the impression that the final finessing to cover the financial trades has been sacrificed in the name of general applicability, when in truth it does not provide a satisfactory basis for the other trades. There was little in *Marine Midland* to give comfort to any other than those carrying on a financial trade and, as SP 3/85 is linked to that case, it might have been wise to have kept within that restriction, with a separate Statement of Practice dealing with non-financial trades.

SP 3/85 accepts without quibble that where currency borrowings are completely matched by currency assets (or currency fixed assets are matched by currency liabilities) and no currency adjustments are made to the Profit and Loss account, the taxable profit will follow the Profit and Loss account basis and tax fragmentation will not occur. This is clear where single currency matching is concerned but SP 3/85 does not address multi-currency matching, although it is difficult to see that the Revenue would be able to ignore the treatment in the Profit and Loss Account on multi-currency matching under SSAP 20. The most difficult area is where currency assets and liabilities are not completely matched and SP 3/85 suggests that the tax position should start at the net currency difference debited or credited in the Profit and Loss account and that that difference should then be analysed to determine tax treatment. This is not precisely what *Marine Midland* was about – there the minute mismatch was reflected in the Profit and Loss account as a revenue item and in any case it was always contended that the foreign currency borrowings were circulating and not fixed capital so the accounting treatment only set off currency gains and losses on revenue items. It is true that before the General Commissioners and before Vinelott, J. in the High Court, the Revenue succeeded in their contention that the foreign currency borrowings of *Marine Midland* were fixed capital and it is this that they are relying on in SP 3/85. However, it is also true to say that the two higher courts did not find it necessary to decide that particular issue and there were a number of indications that the House of Lords might have been persuaded that the borrowings were circulating capital. No doubt this is going to be one of the contentious areas of SP 3/85 when discussions take place between the Revenue and interested parties. Arising directly out of the Revenue's assertion that *Marine Midland* is authority for netting off capital against revenue items if in accordance with standard accounting practice, is the element of double taxation that could arise in some cases under SP 3/85. If one item based in a foreign currency is a fixed asset in the shape of a non-monetary capital asset, then under SP 3/85 it could be revalued each year and taken into account in determining the figure debited or credited to the Profit and Loss account. However, when that asset is disposed of capital gains tax will apply with the gain or loss being determined in relation only to original base cost and not to the annual revaluation figure. There is a provision in s.31, Capital Gains Tax Act 1979, that where an amount has already been taken into account for income or corporation tax purposes then effectively it shall be deducted from the disposal proceeds on the same asset. The Revenue have already made it known that they take the view that the annual revaluation of such a non-monetary capital asset would not constitute an amount to be taken into account for the purposes of

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[1] See Appendix at the end of this article.

s.31. Whether their view is right or wrong – and there are arguments either way – there is little doubt that s.31 was not drafted with this type of problem specifically in mind and the wording does not give a complete answer. Nevertheless, the Revenue do concede that the spectre of double taxation exists and expect this to be yet another item for discussion.

The final problem area in SP 3/85 is that it puts great weight on normal commercial accounting treatment being the basis for sorting out which assets and liabilities might be brought into the pot for matching purposes. A senior Revenue official has already stated that this should be taken to mean all nonfinancial traders following the new U.K. Accounting Standard SSAP 20 which, although a fair attempt by the accountancy profession to start to come to terms with this thorny problem, cannot be expected at this early stage in its existence to provide the answer to every question. Furthermore, there may be very few instances indeed under SSAP 20 where long-term currency borrowings or fixed currency assets are taken into account for matching and reflecting in the Profit and Loss account. Few, if any, nonfinancial trades will benefit from SP 3/85 because the accounting treatment will exclude taking into account – when ascertaining trading profit – any currency movements on foreign currency borrowings which are fixed capital.

It can be said that the Revenue have made an attempt to try and find a basis for a practical solution to some areas which present problems in relation to taxation of currency movements, but at the end of the day they cannot do any more than tinker with a basically faulty tax system in this area. Legislation is what is needed to remove at least some of the more striking anomalies.

CAPITAL GAINS TAX

The *Marine Midland* case did not concern capital gains tax and SP 3/85 winds up by making this point and stating that the decision in *Bentley v. Pike* (1981) STC 360 remains unaffected. That case established that the chargeable gain or allowable loss on chargeable assets denominated in a foreign currency is to be found by translating the foreign currency cost of the asset at the rate of exchange to the pound ruling at the date of acquisition, and by translating the disposal proceeds at the rate of exchange ruling at the date of disposal; thus any currency fluctuation between the pound and the foreign currency on the two dates in question is reflected in the final capital gain or loss.

The realistic approach of the House of Lords in the *Marine Midland* case has prompted discussion whether, in circumstances where a company whose trading operations are conducted on a non-sterling base, any capital gains arising on disposal of capital assets used in that trade should also be computed in the appropriate foreign currency with only the final figure being translated into sterling at the rate of exchange ruling at the date of disposal. This approach was firmly rejected by the High Court in *Bentley v. Pike* which was concerned with the disposal of inherited foreign real estate by an individual. In the writer's opinion there is nothing to distinguish capital gains arising from a trade carried on in a foreign currency from the real estate transaction. This is because capital gains tax is a modern tax with gains and losses being ascertained by reference to a carefully specified formula and the element of commercial measurement used in ascertaining trading profit is not in point.

The real difficulty under the capital gains tax provisions is that any currency gain or loss on repayment of foreign currency borrowings used specifically to purchase an asset denominated in that same foreign currency cannot be set off against the resultant gain or loss arising on the disposal of the asset. It may seem sound commercial practice to borrow in Swiss francs to meet a commitment to purchase heavy machinery for a business in Swiss francs but the tax treatment does not follow the economic reality.

For example, UKCO purchases machinery from SWISSCO for 3 million Swiss francs when the rate of exchange is £ 1 to 5.25 Sfrs. which gives a sterling cost of £ 571,428. To meet the cost, UKCO raises foreign currency borrowings of 3 million Sfrs. Due to unforeseen circumstances shortly after delivery UKCO no longer requires the machinery and is able to sell it to NEWCO for 3 million Sfrs. The pound has weakened in the meantime and at the date of sale the rate of exchange is £ 1 = 3.25 Sfrs. thus showing a sterling receipt of £ 923,078 and a profit on sale of £ 351,650 which is entirely due to the exchange rate movement. On the same date UKCO uses the proceeds of sale to repay the 3 million Sfrs. loan and the extra sterling cost of repaying that loan is £ 351,650, again entirely due to the exchange rate movement. Tax fragmentation is total – the profit on the sale of the machinery is liable to corporation tax on gains at the rate of 30%, but the corresponding loss on repayment of the 3 million Sfrs. loan finance used to purchase the machinery will not be tax deductible, as the loan will be fixed capital in nature.

A similar problem can arise where a currency swap is entered into as a hedge against foreign currency movements on long term foreign currency borrowings as the following example shows:

On 1 January 1985, when the rate of exchange is US$ 1.25 = £ 1, UKCO borrows $ 1.875 million for 5 years at 14% and USCO borrows £ 1.5 million for 5 years at 11%. On 2 January 1985 UKCO and USCO enter into a swap agreement under which both agree in effect to service each other's borrowings. At the end of the 5 year period, when the rate of exchange is $ 1.5 = £ 1, UKCO and USCO have to repay their original debtors and calculate the payment due under the swap agreement. UKCO will, under the example, have to find an additional £ 130,437 in sterling terms to repay its $ 1.875 million loan, but under the swap agreement will receive $ 1.875 million from USCO. In commercial terms UKCO has successfully covered its exchange risk. However, for tax purposes, the two transactions are treated completely separately and tax fragmentation occurs. The original debt will be fixed capital in nature and the exchange loss arising on repayment does not fall to be taken into account for tax purposes. By contrast the matching exchange gain arising from the long term forward contract (the maturity of a currency swap) is taxable, most arguably, as a capital gain at 30%. Accordingly, UKCO can, under a straight currency swap, only effectively cover 70% of any exchange risk on repayment of the original debt.

The above examples do of course show the very worst situation whereby the exchange rate movements show a weakening of sterling over the time period so that the currency gain is taxable and the matching loss not allowable. Had sterling strengthened, then the taxpayer would have achieved the highly desirable result of tax-free gains and allowable losses. The message though is clear – successful exchange risk management is that thought of in after-tax terms. Always check the taxation consequences before deciding on a final strategy.

APPENDIX

Exchange Rate Fluctuations

Statement of Practice SP 3/85 (Provisional) of 25 January 1985[1]

Introduction

1. Following the judgment of the House of Lords in *Pattison v. Marine Midland Limited* (1984) AC 362, [1984] STC 10 the Revenue has been asked for its views on the treatment for tax purposes of profits and losses arising from exchange rate fluctuations. This Provisional Statement attempts to deal with some aspects of this problem. It is put forward as a practical guide to facilitate the preparation and agreement of tax computations. The general rules it contains may need to be modified in the way in which they are applied in particular circumstances.

Marine Midland – a Summary

2. A U.K. resident bank carried on business in international commercial banking. For the purpose of making dollar loans and advances in the course of its banking business, it borrowed 15 million U.S. dollars in the form of subordinated loan stock, redeemable in 10 years. As a result of exchange rate fluctuations, the sterling value of the loans to its customers increased, but so also did the liability in sterling terms of the loan stock. Its general aim was to remain matched in each foreign currency and for the most part the dollar borrowing remained invested in dollar assets. After 5 years the loan stock was repaid out of existing dollar funds and at no time was any of the 15 million dollars converted into sterling.

3. Each year in the accounts, the monetary assets and liabilities denominated in a foreign currency were valued in sterling at the exchange rate at the balance sheet date but to the extent that currency liabilities were matched by currency assets, no profit or loss was shown for accounts purposes. The Court of Appeal and the House of Lords held that in these circumstances no profit or loss arose for tax purposes. On the other hand, any profit or loss arising from an unmatched position was included in the profit and loss account and taken into account for tax purposes. Lord Templeman said that this practice "reflected the bank's success or failure in acquiring and holding an excess of foreign currency over its foreign currency liabilities which it was free to convert". He noted without disapproval the Revenue's acceptance of the practice and said it was ". . . not inconsistent with the company's submission that no profit or loss was attributable to dollar assets equal in dollar terms to dollar liabilities".

Definitions

4. In this Statement –
- *Translation* into sterling is regarded as the valuation of a foreign currency asset or liability in terms of sterling at a particular date;
- *Conversion* into sterling is the exchange of that asset or liability for sterling.

Translation adjustments

5. In the Revenue's view, the decision in *Marine Midland* does not make it necessary to abandon the current practice of bringing translation adjustments on unmatched positions into account for tax purposes. It is clear too that any attempt to deal with exchange profits and losses in respect of such positions only where there is conversion into sterling would present substantial problems of identification and follow up for both taxpayers and their taxation advisers and the Revenue. In addition, it is understood that principles generally accepted in determining for accountancy purposes whether profits are realised, and so properly included in business accounts compiled in accordance with the Companies Acts, permit the inclusion of profits revealed by translation.

Capital and current liabilities

6. The Court of Appeal and the House of Lords did not find it necessary to decide whether the borrowing by Marine Midland was a capital or current liability; the House of Lords indicated that it would have needed further evidence and argument to decide the issue. The Commissioners and the High Court, however, agreed with the Revenue's view that the borrowing was a capital liability. The Revenue remains of the view that the liability in question in the *Marine Midland* case was of a capital nature.

Matched assets and liabilities

7. The judgments of the Court of Appeal and the House of Lords indicate that where currency borrowings are matched by currency assets in circumstances that no exchange adjustments are made to the profit and loss account, the capital or current nature of the borrowing will no longer be relevant in determining whether such adjustments are to be made for the purposes of computing trading profits or losses for tax. In these circumstances exchange differences, whether profits or losses, arising on long term borrowings are not to be distinguished and adjusted in computing trading profits or losses for tax.

8. The revenue takes the view that the logic of *Marine Midland* applies also where currency fixed assets are matched by currency liabilities; again exchange differences arising on the

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assets or liabilities are not to be distinguished and adjusted for the purposes of computing trading profits or losses for tax.

9. Liabilities and assets are regarded as matched to the extent that currency assets are equalled by currency liabilities in the same currency and a translation adjustment on one would be cancelled out by a translation adjustment on the other.

Assets and liabilities not matched

10. Where currency assets are not matched, or not completely matched, with currency liabilities, consideration of the tax position starts with the net exchange difference debited or credited in the profit and loss account. (Where exchange differences relating to assets or liabilities not matched, or not completely matched, are taken to reserve, the nature of the assets or liabilities will need to be considered to determine whether or not a tax adjustment is required.)

11. In order to decide what adjustment is required in the tax computation to the net exchange difference debited or credited in the profit and loss account the following procedure should be adopted. The first step will be to ascertain the aggregate of exchange differences, positive and negative, on capital assets and liabilities in the profit and loss account figure;

(a) If there are no such differences then no tax adjustment is necessary.

EXAMPLE 1

A company normally trading in sterling incurs a liability on a trade debt of $600,000 when $1.5 = £1. the liability is entered in the books in sterling at £400,000. By the accounting date sterling has fallen to $1.25 = £1, so that the sterling value of the liability has increased to £480,000. The exchange loss of £80,000 is charged to the Profit and Loss Account.

There were no capital exchange differences. No adjustment is required for tax purposes because the transactions are wholly on revenue account.

(b) If the net exchange difference on capital items is a loss and the net difference in the profit and loss account is also a loss, the smaller of the two figures is the amount ot be disallowed in the tax computation as relating to capital transactions.

EXAMPLE 2

A trading company borrows $600,000 on long-term capital account when $1.5 = £1. It retains $150,000 as current assets and converts the balance of $450,000 to £300,000. The books will then show the following entries –

Capital loan ($600,000)	£400,000	Current assets ($150,000)	£100,000
		Cash on hand	£300,000
	£400,000		£400,000

By the accounting date when sterling has fallen to $1.25 = £1 these become –

Capital loan ($600,000)	£480,000	Current assets ($150,000)	£120,000
		Cash on hand	£300,000
		Exchange difference to Profit & Loss Account	£ 60,000
	£480,000		£480,000

The exchange difference on capital account is £80,000 (£480,000–£400,000) but the tax adjustment is limited to the amount charged to the Profit and Loss Account so that £60,000 is disallowed. This reflects the fact that $150,000 of the liability is matched with $150,000 assets. The whole of the exchange difference £60,000 is attributable to the excess currency liability on capital account, the value of which has increased from £300,000 to £360,000.

EXAMPLE 3

A trading company incurs a liability by way of overdraft on current account of $300,000 and borrows $600,000 on capital account when $1.5 = £1. It retains $150,000 as current assets and converts the balance of $750,000 to £500,000. The books will then show the following items –

Capital loan ($600,000)	£400,000	Current assets ($150,000)	£100,000
Overdraft on current account ($300,000)	£200,000	Cash on hand	£500,000
	£600,000		£600,000

By the accounting date sterling has fallen to $1.25 = £1 and the book entries are then –

Capital loan ($600,000)	£480,000	Current assets ($150,000)	£120,000
Overdraft on current account ($300,000)	£240,000	Cash on hand	£500,000
		Exchange difference to Profit & Loss Account	£100,000
	£720,000		£720,000

The net exchange loss of £100,000 in the Profit and Loss Account is made up of £120,000 loss on the liabilities and £20,000 profit on the assets.

The exchange difference on capital account is £80,000 (£480,000–£400,000). This is less than the Profit and Loss Account figure so the £80,000 is disallowed for tax purposes. This reflects the matching of the $150,000 current assets with $150,000 of the current liabilities. The capital liability is therefore wholly unmatched.

(c) If the net exchange difference on capital items is a profit and the net difference in the Profit and Loss Account is also a profit, then the smaller of the two figures is the amount to be deducted in the tax computation.

EXAMPLE 4

A trading company incurs a liability by way of overdraft on current account of $150,000 and borrows a further £300,000 as a capital loan when $1.5 = £1. It converts the £300,000 to $450,000 and acquires capital assets for $600,000. The books will then show the following entries –

Overdraft on current account ($150,000)	£100,000	Capital assets ($600,000)	£400,000
Capital loan	£300,000		
	£400,000		£400,000

By the account date sterling has fallen to $1.25 = £1 and the book entries are as follows –

Overdraft on current account ($150,000)	£120,000	Capital assets ($600,000)	£480,000
Capital loan	£300,000		
Exchange difference to Profit & Loss Account	£ 60,000		
	£480,000		£480,000

The net exchange profit of £60,000 in the Profit and Loss Account comprises £80,000 profit on the assets and £20,000 loss on the liability.

The net capital exchange difference is £80,000 (£480,000–£400,000) but the adjustment for tax purposes is limited to the figure in the Profit and Loss Account of £60,000. This reflects the fact that $150,000 of the assets are matched with the dollar liability. The non-taxable exchange profit is attributable to the excess capital assets, whose sterling value changed from £300,000 to £360,000.

(d) Where the net exchange difference on capital items produces a loss but the net difference in the Profit and Loss Account is a credit entry, then no tax adjustment is required. Similarly no adjustment is necessary where there is a profit in respect of exchange differences on capital items but a net loss on exchange is debited to the Profit and Loss Account.

EXAMPLE 5

A trading company borrows $900,000 on capital account and raises a further sterling loan of £200,000. It converts the £200,000 to $300,000 and buys capital assets for $750,000. At this time $1.5 = £1. The balance of $450,000 is retained as a current asset. The books show the following entries at this point –

Capital loan ($900,000)	£600,000	Capital assets ($750,000)	£500,000
Capital loan	£200,000	Current assets ($450,000)	£300,000
	£800,000		£800,000

By the accounting date the exchange rate alters to $1.25 = £1 and the book entries become –

Capital loan ($900,000)	£720,000	Capital assets ($750,000)	£600,000
Capital loan	£200,000	Currents assets ($450,000)	£360,000
Exchange difference to Profit and Loss Account	£ 40,000		
	£960,000		£960,000

The Profit and Loss Account entry for the net exchange profit of £40,000 is made up of £160,000 profit on the assets and £120,000 loss on the liability.

The net capital exchange difference is a debit of £20,000 i.e. (£720,000–£600,000) – (£600,000–£500,000) but the Profits and Loss Account shows a net credit of £40,000. No adjustment is therefore required for tax purposes. This reflects the matching of the net capital liability of $150,000 with part of the dollar current assets. The taxable exchange profit of £40,000 is attributable to the balance of the dollar current assets, whose value increased from £200,000 to £240,000.

(e) It follows that normally the amount of any tax adjustment is limited in each case to the credit or debit for net exchange difference in the Profit and Loss Account.

Assets held on the "realisation" basis

12. Some financial concerns hold assets, the profits on the disposal of which are treated for tax purposes as receipts of their trade but which are not stock in trade. Such profits are assessable only when the assets are disposed of (the "realisation" basis). Nevertheless it may be the practice for accounting purposes to revalue the assets to reflect exchange rate fluctuations. Where the resulting exchange differences are either taken to Profit and Loss Account or set off against exchange differences on liabilities as part of the matching process, with the result that the profits or losses on realisation are recognised for accounts purposes effectively net of exchange differences, the Revenue will normally be prepared to follow the accounts treatment for tax, provided that this is applied consistently.

EXAMPLE 6

A financial concern borrows $600,000 on capital account and raises a further sterling loan of £200,000. It converts the £200,000 to $300,000 and buys financial assets (realisation basis) for $900,000. At this time $1.5 = £1. The books then show the following entries –

Capital loan ($600,000)	£400,000	Cost of financial assets ($900,000)	£600,000
Capital loan	£200,000		
	£600,000		£600,000

At the accounting date the rate of exchange is $1.25 = £1 so entries are as follows –

Capital loan ($600,000)	£480,000	Financial assets ($900,000)	£720,000
Capital loan	£200,000		
Exchange difference to Profit & Loss Account	£ 40,000		
	£720,000		£720,000

Since the capital exchange difference is a debit of £80,000 (£480,000–£400,000) and there is a net credit of £40,000 overall, no tax adjustment to the £40,000 is needed.

At the end of the next accounting period the rate of exchange has altered to $1.2 = £1 and the assets are sold so the entries become –

Capital loan ($600,000)		£ 500,000	Cash proceeds of sale of financial assets ($1,200,000)	£1,000,000
Capital loan		£ 200,000		
Exchange difference for Year 2 to Profit & Loss Account	£ 10,000			
Exchange difference for Year 1 brought forward	£ 40,000			
*Profit on realisation of assets	£250,000	£ 300,000		
		£1,000,000		£1,000,000

* Sale proceeds $1.2m less cost $0.9m giving a profit of realisation of $0.3m or (at $1.2 = £1) £250,000. The exchange profit from holding the $900,000 assets while the exchange rate moved from $1.5 = £1 to $1.2 = £1 has already been taken into account in the exchange differences.

The capital exchange difference is a loss on the loan of £20,000 (£500,000–£480,000) but there is a profit of £30,000 in respect of current assets, i.e. £750,000 ($900,000 at $1.2 = £1) – £720,000. Thus, there is no adjustment to the figure in the Profit and Loss Account for the exchange difference.

Capital gains

13. The decision in *Bentley v Pike* 53 TC 590, [1981] STC 360, established that a gain or loss on an asset should be computed by comparing the sterling value at the date of sale of the sale consideration with the sterling value at the date of acquisition of the acquisition cost. This principle is not affected by the *Marine Midland* decision which is concerned only with the computation of trading profits.

(This Provisional Statement has no binding force and does not affect a taxpayer's rights of appeal on points concerning his liability to tax.

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[continued from p. 370]

manager and hence would be a ready source of up to date information;

d. to implement computerised support, based on the better structure of the information, and taking advantage of progress generally on the computer front and in decision support systems.

36. The second major problem is the link between the SMS and the planning for the longer term. The time horizon for the SMS is some 18 months in which we look through to the end of the next financial year. This year there was the forward look with the Board's medium term management strategy but this is as far as we have gone to date in the context of the SMS. Since the money the Department will eventually get to meet its running costs is now to a large extent determined by discussions with the Treasury about the bids the Department makes as part of the Government's Public Expenditure Survey (PES) (which for the current round looks ahead to 1988/89) then long term planning is already of vital importance to top management. In common with other Departments we need to consider how the process which determines our PES bid should relate to the top management system. Should it be fully integrated or should it stand along side? Whichever route we choose, we need to ensure that the framework which PES provides is reflected in the shorter term information which is currently reviewed as part of the SMS, and in turn any outcome of the review gets reflected in the longer term plans.

CONCLUSIONS

42. In conclusion the SMS has so far proved a useful instrument for top management, although it is still early days. Generally it has sharpened the management process, and in particular it has provided a means for identifying specific problems and the opportunity for change. As the rest of our FMI plans develop, the impetus will be maintained. There remain some open points about how we can improve its effectiveness further by using, for example, computer support to provide what would be a top management database. In addition we need to explore further how the various management processes of long term planning, budget and target setting, monitoring and performance reviews should relate one to another. Should we seek to extend the current approach with the SMS to cover all these or should we be developing it more as an information and decision support system to help top and senior managers in these various processes? Whichever way we go it is clear that, if Department is to be successful in the programme of work that lies ahead and the amount of change that is involved, then management at senior levels will need effective and flexible systems to support them, one of which must be the SMS.

43. I should just make one final point. This article has been about management systems. In doing this I may have given the impression that the human factor does not matter; that given a well designed information system such management skills as intuition or judgement are of little consequence. This could not be further from the truth. The history of management practice has sufficient examples of systems not working when transferred to another organisation, simply because of the failure to realise the pivotal role that managers play. So in seeking to improve the Department's efficiency and effectiveness, we have not only to build on the successes we have had to date with the development of the management systems I have been describing, but also – and arguably this is the more important and difficult side of the equation – we have to continue to generate the right organisational ethos in which management skills as a whole are acquired and are encouraged to develop.

CANADA:
Some Current Issues with Treaty Tax-sparing Provisions

By Nathan Boidman

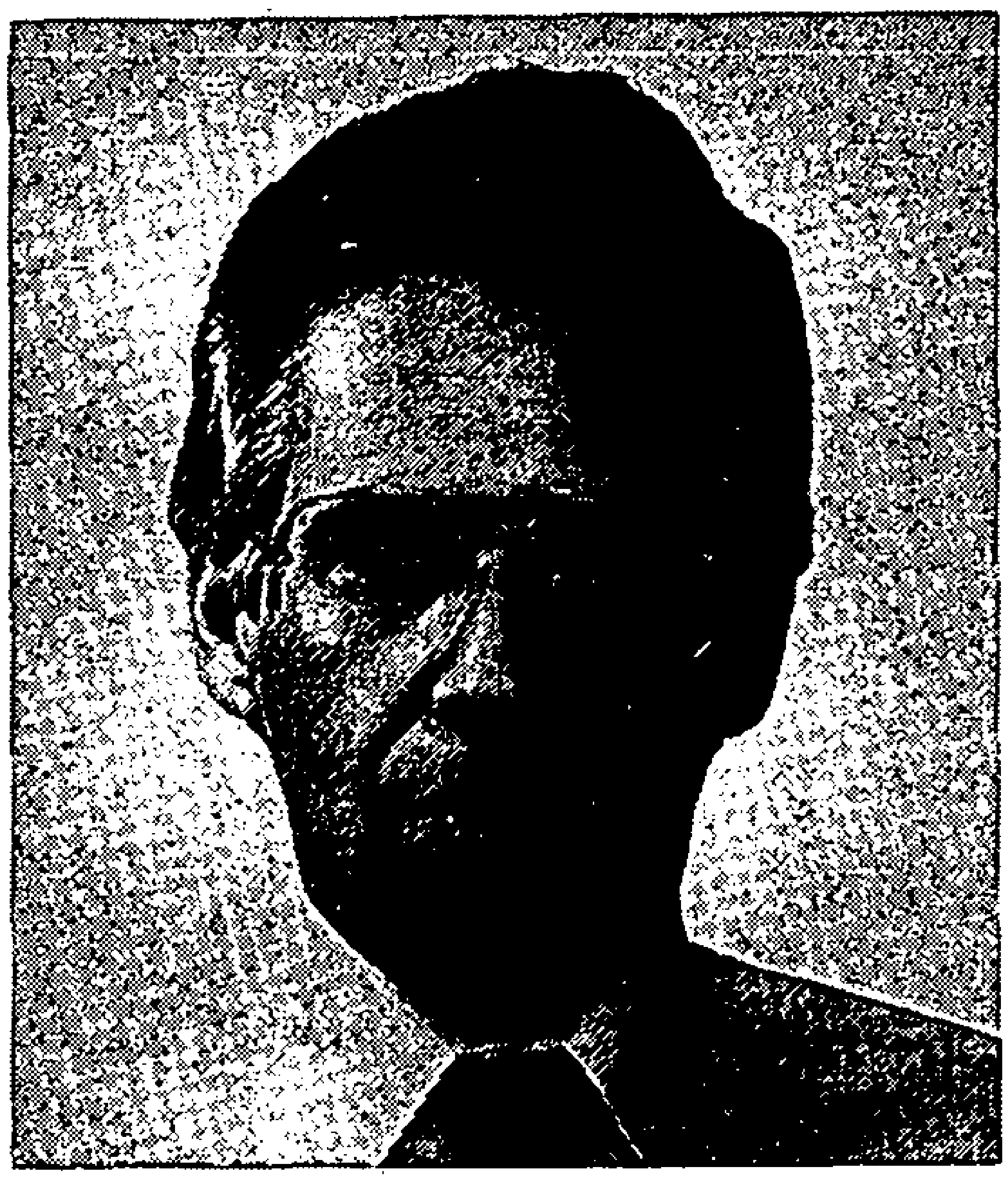
I. OVERVIEW

A case now before the Canadian courts illustrates issues which can arise in applying "tax-sparing" provisions under double tax agreements – designed to encourage foreign investment in developing countries. Of more common knowledge are policy issues, and in particular the reluctance of the U.S. to grant tax sparing, in respect of the rapidly increasing number of double tax treaties with developing countries. This article briefly reviews the nature and role of tax-sparing provisions in the context of such current issues.

Double tax agreements normally have two principal objectives: the avoidance of double tax and the elimination of fiscal avoidance and evasion, the latter entailing exchange of information and related (e.g. simultaneous audit) procedures.[1]

"Tax-sparing" or "matching credits" may properly be viewed as a third objective of a treaty, the purpose of which is to preserve the economic benefits for a developing country arising from tax holidays or other incentives granted by such developing country. The role of tax-sparing can perhaps best be considered in the context of a brief review of the operation of the rules for avoiding double tax which really are made up of two inter-connected components: a rule for allocating prime taxing jurisdiction and the direct rule of avoiding double tax.

Inherent in all double tax agreements is a series of rules designed to allocate to one of the two contracting states primary jurisdiction for taxing various types of income earned by a resident of one state in the other. The allocation is governed by economic and trade considerations, given that all domestic tax systems are generally based on the assumption that a country has the right to tax income sourced in or arising within its borders. Where a Canadian company, for example, carries on business directly in Germany, the primary right to tax such business profits, both as a matter of German domestic law and the Canada-Germany Income Tax Convention, will normally be that of Germany with exemption from German tax arising in certain defined and narrow circumstances. Such circumstances are determined by reference to economic and business considerations, particularly questions of administrative convenience and practicality. Inasmuch as Germany is the country where the profit is generated, it normally would be considered to have the prime claim for tax; such right is given priority where the degree of continuity or substantial presence in Germany by the Canadian company is sufficient to outweigh the apparent inconvenience or costs associated with complying with German tax law. The line of demarcation is determined under the Canada-Germany Income Tax Convention (as it is generally in all double tax agreements, particularly those patterned on the OECD 1977 Model) by measuring the degree of substantial presence through the "permanent establishment" test. Only where the Canadian company carries on such direct business in Germany through a permanent establishment will the treaty allow Germany to levy tax.



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Since 1964, Mr. Boidman has restricted his practice to consulting in tax matters – he has written numerous articles and papers on international tax and lectures frequently on the topic.

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He has written a book entitled "The foreign affiliate system: Canadian taxation after 1982 – a structured overview" published in April 1983 by CCH Canadian Limited and has co-authored a book (with Bruno Ducharme) entitled "Taxation in Canada – implications for foreign investment", published by Kluwer.

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[1] Double tax agreements typically do not, however, require cooperation in enforcement of tax claims and to this end the Organisation for Economic Co-operation and Development (O.E.C.D.) has sponsored a Model Convention, "Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims", complementing the basic double tax treaty model "Model Double Taxation Convention on Income and on Capital", embodying the rules for achieving the two principal purposes of avoiding double tax and combatting avoidance and evasion.

If the activities of the Canadian company are transient and occasional (such that they do not amount to the carrying on of business through a permanent establishment) and even though under the concepts of Germany's national tax system a claim may arise, the treaty will call for Germany to forego its claim and the prime jurisdiction for tax will shift to Canada.[2]

The taxing jurisdiction may sometimes be allocated, effectively, to both jurisdictions by requiring sharing of the taxing power. This normally arises in the case of certain passive types of payments (e.g. interest, dividends, royalties and rents) where the right of the source or host country is maintained and given priority but is limited by establishing the maximum amount of tax that may be levied by that country. In the typical modern generation treaty to which Canada is a contracting state (and to some extent in derogation from the recommendations of the OECD 1977 Model) the host or source country may levy a tax of 15% on dividends or interest and 10% on royalties, with the balance of the taxing jurisdiction effectively being allocated to the country of residence.

The direct rule for avoiding double tax comes into focus after the jurisdiction to tax has been allocated. Its purpose is to ensure that where the host or source country has been allocated the right to tax income, in whole or in part, in accordance with the rules noted earlier, the country of residence will provide a credit or reduction in the taxes which it imposes (under the standard rule in certain countries such as Canada which levies tax on worldwide income of residents) in recognition of and relief from the tax payable to the source country. This rule is intended to eliminate double taxation which could arise where either the country of residence does not unilaterally provide (under domestic law) for relief in respect of foreign taxes or where the domestic tax credit rules would be ineffective, by reason perhaps of sourcing concepts or quantum limitations.[3]

For example, if a Canadian company pays German tax on business profits earned in Germany through a permanent establishment at the rate of say 50%, then Canada which would normally tax any profits at roughly the same rate is required to provide a deduction for German taxes, thereby eliminating all Canadian taxes on such income.[4]

Accordingly, a normal function of a treaty is to eliminate double taxation where the primary right of taxation has been assigned to the host or source country.

II. TAX-SPARING

As a general matter the foregoing objectives are not only the most but often the only significant aspects of double tax agreements (aside from those relevant to combatting tax evasion). However, many developed countries such as Canada have entered into an additional type of arrangement designed to spur economic development in less developed countries, namely the rules related to "tax-sparing".[5] This arrangement essentially comprises an agreement by the developed country to grant its resident a credit for all or part of the tax which would normally be payable to the developing state, pursuant to its domestic rules and the principles for allocating jurisdiction to tax discussed earlier, but where such source country tax has been reduced or eliminated, in whole or in part, by the less developed country under certain specified incentive programs designed to spur foreign investment in such country. In effect the credit is granted for taxes which are not in fact payable to the developing country.

Such arrangement, in the context of a developed country which grants, under domestic law, relief for foreign taxation by the tax credit method and not the territorial exemption method has been described as "allowing a foreign tax credit for taxes that the treaty partner levies by normal operation of its domestic law but which it chooses to abate, in whole or in part, in respect of particular investments".[6]

Tax-sparing is not simply a case of providing under the treaty for an avoidance of double taxation but rather has an entirely different purpose: to exempt a developed country (say Canadian) investor in whole or in part from taxes in both countries in order that the Canadian be induced or encouraged to carry out the particular activity in the less developed country. Canada has adopted such provisions in several of its treaties with less developed countries including those with Bangladesh, Barbados, Cameroon, Cyprus, Dominican Republic, Egypt, Indonesia, Israel, Ireland, Ivory Coast,

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[2] Gérard Coulombe, at that time second-in-command in Canada's treaty negotiations, expressed this matter in a paper delivered in 1976 to the Canadian Tax Foundation Annual Conference as follows (having noted that, as a primary objective in respect of the promotion of international trade and investment, "the existence of a tax treaty enshrining the basis, as well as the rate, of the applicable taxes will generate certainty and will provide a general air of tax stability that can only be reassuring to investors and traders"):

"The second purpose of tax treaties is to reduce the so-called tax harassment or tax annoyance. These terms refer to the burden of compliance of taxpayers from one country who have only minimal contacts with another country. For example, the tax treaty will reduce the burden of compliance of a Canadian company having no substantial contact with another country, by eliminating the necessity of filing returns and paying tax to the source country if it has no permanent establishment in that country."

Gérard Coulombe, "Certain Policy Aspects of Canadian Tax Treaties", *Twenty-Eighth Tax Conference,* Canadian Tax Foundation, 1976, at 291 and 292.

[3] Where the domestic law of a country is based on a territorial concept pursuant to which the resident is not taxed on foreign source income – generally not the case in Canada, the U.S. or the U.K., but seen in some continental European countries – the avoidance of double taxation under a treaty would not require a treaty tax credit mechanism but rather affirmation of the applicability of such rule for territorial exemption.

[4] Canada in fact unilaterally provides for foreign tax credit in respect of directly earned foreign business profits pursuant to section 126 of the Income Tax Act; as well exemption from Canadian tax can arise in respect of profits earned through and distributed by a foreign subsidiary, regardless of the taxes actually paid by the subsidiary to the host country where the country involved has treaty relations with Canada so as to bring into play the so-called "exempt surplus rules" (*inter alia* sections 95 and 113 of the Income Tax Act and Part 5900 of the Income Tax Regulations), a form of territorial taxation.

[5] Other countries include Australia, Germany, Italy, Norway, Sweden and Switzerland.

[6] H. David Rosenbloom, "Current Development In Regard To Tax Treaties", Fortieth Annual N.Y.U. Institute, Chapter 31 at 31-79.

Jamaica, Kenya, Korea, Liberia, Malaysia, Morocco, Pakistan, Romania, Singapore, Spain, Thailand, Tunisia and Zambia. For example, where a Canadian company has earned a profit from carrying on a direct business operation in Israel and would normally be subject to say 50% tax under Israeli law and a 50% tax under Canadian law, the purpose of the tax-sparing arrangement is that to the extent Israel has primary right to tax that income (because it has been carried on through a permanent establishment) but has "spared" that tax pursant to a domestic incentive program, then Canada also agrees to exempt such income from Canadian tax, with the result that the company pays tax in neither country in order to achieve the purposes of the incentive legislation in accordance with the agreement as negotiated between the two countries.

The technique used to achieve the tax sparing objective is to require that the developed country grant relief for the taxes which would normally have been payable in the absence of the incentive legislation notwithstanding that tax has been exempted in the host country pursuant to such legislation. The matter is addressed by the United Nations Model Double Taxation Convention between Developed and Developing Countries and, generally, as follows (under the Commentary on Article XXIII B):

> In certain cases a State, especially a developing country, may for particular reasons give concessions to taxpayers, e.g. tax incentive reliefs, to encourage industrial output. In a similar way, a State may exempt from tax certain kinds of income, e.g. pensions to war-wounded soldiers.
>
> When such a State concludes a convention with a State which applies the exemption method, no restriction of the relief given to the taxpayers arises, because that other State must give exemption regardless of the amount of tax, if any, imposed in the State of source. But when the other State applies the credit method, the concession may be nullified to the extent that such other State will allow a deduction only of the tax paid in the State of source. By reason of the concessions, that other State secures what may be called an uncovenanted gain for its own Exchequer.
>
> Should the two States agree that the benefit of the concessions, given to the taxpayers in the State of source, are not to be nullified, a derogation from paragraph 2 of Article XXIII A or from Article XXIII B will be necessary.
>
> Various formulae can be used to this effect as for example:
>
> (a) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (e.g. limitations of rates provided for dividends and interest in Articles X and XI) even if the State of source, as a developing country, has waived all or part of that tax under special provisions for the promotion of its economic development;
>
> (b) as a counterpart for the tax sacrifice which the developing country makes by reducing in a general way its tax at the source, the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;
>
> (c) the State of residence exempts the income which has benefitted from tax incentives in the developing country.

III. POLICY ISSUES

Issues in respect of tax-sparing provisions are of two kinds. First there are threshold policy issues where a country refuses to negotiate and grant tax sparing arrangements with a developing country. Second, as has arisen in Canada in a recent situation involving the Canada-Israel Income Tax Convention, there can be some resistance by tax authorities to applying the tax-sparing rule in a generous and liberal fashion.

With respect to the threshold policy issues, the main difficulty for developing countries, as a practical matter, stems from the continuing refusal of the United States to adopt tax sparing arrangements in its treaties. The U.S. position has been aptly summed up by H. David Rosenbloom, formerly International Tax Counsel, United States Treasury Department (and in charge of treaty negotiations) as follows:

> Accommodation to developing country goals would be accelerated if the United States chose to abandon its 'traditional' view that tax treaties should not be used to provide incentives for U.S. investment abroad or to validate, through tax-sparing or matching credits, the investment incentives provided by developing country treaty partners. The U.S. policy on this point was established through a series of Senate hearings on proposed treaties over a period of ten years beginning in the later 1950s. There has been no Senate consideration of the issue since 1967, and it is not clear whether the 'traditional' view still prevails. The policy has proved to be of such importance to the U.S. tax treaty program, and so much in contrast both to the interests that many developing countries claim to have and the practice of other developed countries, that a further review might be useful. In fact a multitude of potential policies are at issue, and these policies deserve careful examination, one by one.[7]

Mr. Rosenbloom went on to note that U.S. domestic law does, in fact, provide some of the effects sought by developing countries in tax sparing arrangements:

> It might be possible for the United States as well to adopt a policy of 'tax sparing' without creating a new and powerful incentive for investment abroad . . . .[8]
>
> By refusing to offer tax sparing or other investment incentive provisions, the United States argues to developing countries that a combination of its domestic law rules providing generally for no current taxation of the foreign income of foreign corporations, the overall limitation on the foreign tax credit, and the rules providing that dividends are attributable to the most recent years first effectively produce an economic result not greatly dissimilar from tax sparing . . . . The argument, in effect, is that U.S. law allows indefinite deferral for precisely that income likely to be the subject of source-country investment incentives, or the alternative of exemption achieved by averaging the low – or non-taxed income – with higher-taxed income earned in other countries.

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[7] *Supra* note 6, at page 31-78 and 79.

[8] *Supra* note 6, at page 31-80.

> Though essentially correct, the argument is very difficult to explain.[9]

Mr. Rosenbloom concludes his comments on tax sparing by indicating that its absence need not be fatal in drafting treaties with developing countries:

> Without incentive provisions in its negotiating arsenal, the United States must rely upon flexibility and imagination in seeking to mesh the U.S. system with the tax systems of the developing world. The process has been slow and laborious, and the results have not always been received enthusiastically. Nevertheless, there is increasingly strong evidence that there can be a U.S. tax network with developing countries even in the absence of incentive provisions.[10]

IV. ISSUES RESPECTING APPLICATION

So much for policy issues. As far as the problems of applying tax sparing provisions, such as they exist, the focus shifts to Canada where, generally in respect of treaty issues, reported court decisions reveal an ongoing struggle between the tax authorities often seeking to apply treaties as though they were domestic law and thus arguably governed by rules of strict or literal construction and interpretation and the courts generally seeking to uphold the notion that a treaty should be interpreted in a broad and liberal fashion as will achieve the intentions of the parties negotiating the treaty; allowance must be made for the inherent dissymmetry between domestic tax systems and the methodology and language employed in double tax agreements which can easily give rise to technical deficiencies in treaty provisions which, if applied in a strict and literal fashion, would defeat legitimate claims for exemption or relief under treaty arrangements.

This principle was forcefully reiterated by the Federal Court Trial Division as recently as January of this year where in upholding a claim by a U.S. estate for exemption from Canadian tax in respect of a "deemed disposition of Canadian property on death" (denied by Revenue Canada on the basis that Article VIII of the 1942 Canada-U.S. Income Tax Convention would only exempt a gain from a "sale or exchange") Mr. Justice Addy stated:

> Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned.
>
> Article 31 of the Vienna Convention on the Law of Treaties (1969) to which Canada subscribed governs the general rule of interpretation to be applied. Paragraph 1 of that Article reads as follows:
>
> "1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."
>
> . . .
>
> "The accepted principle appears to be that a taxing Act must be construed against either the Crown or the person sought to be charged, with perfect strictness – so far as the intention of Parliament is discoverable. Where a tax convention is involved, however, the situation is different and a liberal interpretation is usual, in the interests of the comity of nations. Tax conventions are negotiated primarily to remedy a subject's tax position by the avoidance of double taxation rather than to make it more burdensome."
>
> . . .
>
> I fully agree with and adopt the statement of David A. Ward in his paper on The Principles to be Applied in Interpreting Tax Treaties, which is reproduced at page 264 of the 1977 Canadian Tax Journal. The passage in question reads as follows:
>
> ". . . In interpreting and applying treaties, the courts have said that they should be prepared to extend 'a liberal and extended construction' to avoid an anomaly 'which a contrary construction would lead to'. As the court has recognized that we cannot expect to find the same nicety of strict definition as in modern documents, such as deeds, or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use legal accuracy, but rather to adopt more liberal terms.
>
> Therefore, the weight of authority would appear to be against the type of strict interpretation of a tax treaty which would normally be applied to an exempting provision of fiscal legislation. The justification for this general rule of interpretation probably lies in the contractual nature of a tax treaty rather than in its formal ratification by Parliament as legislation."[11]

The interpretational issue in respect of tax-sparing has arisen in the context of a claim, pursuant to Article XXIII of the Canada-Israel Income Tax Convention, by a Canadian corporation which owned shares in an Israeli operating company through an Israeli holding company for credit in respect of Israeli taxes exempted by special incentive legislation. The elements of the issue are as follows:

- Article XXIII(1)(a) of that Convention requires Canada to grant credit for Israeli taxes which may be imposed on Israeli source income.[12]
- Article XXIII(2) requires Canada to recognize such credit in respect of taxes otherwise arising which are exempted under, *inter alia,* the incentive provisions of the Israeli Corporation Ltd. Law, 5729-1969.[13]

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[9] *Supra* note 6, footnote 212 at page 31-80.

[10] *Supra* note 6, at page 31-81.

[11] *Gladden Estate* v. *The Queen,* 85 DTC 5188 at 5191; see also *Sounders* v. *M.N.R.,* 54 DTC 524; *Shahmoon* v. *M.N.R.,* 75 DTC 275; *Canadian Pacific Limited* v. *Her Majesty the Queen,* 77 DTC 5383; *Her Majesty the Queen* v. *John M. Cruickshank,* 77 DTC 5226; *Peter J. Appleby* v. *M.N.R.,* 79 DTC 2168; *Hunter Douglas* v. *Her Majesty the Queen,* 79 DTC 5340; and, generally, Nathan Boidman, "Interpretation of Tax Treaties in Canada", *Bulletin for international fiscal documentation* (1980) at 388; and David A. Ward, "Principles to be Applied in Interpreting Tax Treaties", *Canadian Tax Journal,* (1977) at 263.

[12] Article XXIII(1)(a) provides as follows:
"Subject to the existing provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada and to any subsequent modification of those provisions (which shall not affect the general principle hereof) and unless a greater deduction or relief is provided under the laws of Canada, Israel tax payable under the law of Israel and in accordance with this Convention on profits, income or gains arising in Israel shall be deducted from any Canadian tax payable in respect of such profits, income or gains."

[13] Article XXIII(2) reads as follows:
"2. For the purpose of paragraph 1(a), Israeli tax payable by a resident of

- The tax-sparing rule would have been clearly applicable, without dispute, had the Canadian taxpayer owned the shares of the Israeli operating company directly. In such cases and because the taxpayer owned less than 10% of the stock of the Israeli company, the full amount of the dividends, before any Israeli withholding tax, would have been included in income[14] and a credit for Israeli taxes, including the notional Israeli tax arising under the tax sparing rule, would have arisen pursuant to section 126 of the Income Tax Act, which provides for direct foreign tax credit.[15]
- The dispute arose because the shares were owned through the Israeli holding company. Under domestic Canadian law the dividends paid by the Israeli operating company remained subject to tax, by reason of the Foreign Accrual Property Income Attribution System, adopted in Canada in 1976, whereby passive income of a foreign holding company ("controlled foreign affiliate") is effectively taxed in the hands of the Canadian shareholder.[16]
- In such circumstances effective relief for taxes levied on the dividends paid by the operating company to the holding company did not arise under Canadian domestic law pursuant to the direct foreign tax credit rules of section 126 but rather by way of a system of deductions in computing income: pursuant to subsection 91(4), the foreign tax, grossed up by a factor intended to achieve the same numerical result as the section 126 foreign tax credit rules, is allowed as a deduction in computing the net income inclusion from the attributed passive investment (in this case dividend) income. The taxpayer claimed that such deductions pursuant to subsection 91(4) (as well as that arising under related rules in respect of the distribution through the holding company to the Canadian taxpayer) should include the taxes spared pursuant to the Israeli incentive legislation, all in accordance with the provisions of Article XXIII.

The Revenue authorities refused to take into account the spared Israeli taxes in determining the deductions permitted in computing income pursuant to the rules just noted on the basis that Article XXIII required a direct deduction in computing income. The issue therefore is whether Article XXIII should be interpreted in a broad and liberal fashion as the taxpayer argues or in a straightforward, grammatical and essentially technical fashion as the Revenue authorities argue. It is worth noting that, having regard to the overall nature and role of tax-sparing, in support of their position the tax authorities argued to the effect that Article XXIII need not be unduly "interpreted" in order to grant the taxpayer's claim for the reason that to deny the claim would not lead to a case of double taxation. This is correct but it would obviously conflict with the essential purpose of the tax-sparing rule. The case has been heard by the Tax Court of Canada and is "en deliberé".

While it would seem that similar types of issues respecting the tax-sparing rule have not arisen in other countries, it is not difficult to visualize other circumstances in which such issues could arise and the Canadian Tax Court's decision could be an important precedent for tax treaties between developed and developing countries which contain tax-sparing provisions.

Canada
(a) in respect of profits attributable to a trade or business carried on by it in Israel, or
(b) in respect of dividends or interest received by it from a company which is a resident of Israel,
shall be deemed to include any amount which would have been payable as Israeli tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under –
(c) . . . any of the following provisions, that is to say: . . . sections 5 and 6 of the Israeli Corporation Ltd. Law, 5729-1969; . . .
(d) any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character."

[14] Section 90 of the Income Tax Act.

[15] It should be noted that, had 10% or more of the shares of the Israeli company been owned by the Canadian taxpayer, directly or as in the case under review, through a non-Canadian holding company, total exemption under Canadian tax would arise under Canada's "exempt surplus" rules which, in general terms, exempt a Canadian corporation from tax on dividends received from a "foreign affiliate" (i.e. one in which there is an ownership of 10% or more of any class of stock held directly or indirectly), which is resident and carries on business in a treaty country and the affiliate's profits are derived from the conduct of an active business: see Nathan Boidman, "The Foreign Affiliate System: Canadian Taxation after 1982 – A Structured Overview", 1983, *CCH Canadian Limited.*

[16] See, *inter alia*, subsection 91(1) of the Income Tax Act; for a general description of the system, see *Boidman, supra* note 15.

An authoritative per-article commentary on the Double Taxation Treaty between the United States and the Federal Republic of Germany, including summaries of their national tax systems:

HANDBOOK ON THE UNITED STATES-GERMAN TAX CONVENTION

— DEBATIN/WALTER —

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The Role of Tax Treaties as an Instrument of Economic Cooperation between "Capitalist" and "Socialist" Countries

By Helmut Debatin

I. INTRODUCTION

1. The traditional concept of double taxation

International double taxation is traditionally understood to exist where two or more states subject the same taxpayer to identical or similar taxes with respect to the same tax object.[1] A problem already exists to define the object subject to taxation as can be easily seen from the basic concept of "income". Since income is measured over time, it will not necessarily be the same in both states concerned. For instance, if one state grants a higher initial depreciation than the other one, taxable income in the first mentioned state will initially be lower in comparison to the situation in the other state but will be relatively higher in subsequent years, whereas in the other state – because of a lower initial depreciation – the income derived from such economic activity will be higher in the beginning and decline in later years. This simple example clearly demonstrates that the term "double taxation" cannot be taken as a fixed concept with a definite meaning but is rather understood to describe a phenomenon.

2. States determine measures for avoidance of double taxation

Taking as a starting point the situation, generally understood to require relief, of the imposition of similar taxes by two or more states on the same taxpayer with respect to income in the same period of time, there are many extensions, ramifications and special conditions which reach beyond the traditional notion of double taxation but nevertheless involve tax grievances which call for remedy. This supports the conclusion that the countries, themselves, determine what they wish to avoid as double taxation. This is clearly illustrated by actual practice. Either countries adopt unilateral relief measures based on their tax sovereignty – and are therefore anyhow left to their own discretion – or they engage in bilateral conventions – the so-called tax treaties – which, as well, cannot extend further than either contracting state is prepared to concede relief from its tax. All this indicates that international tax treaties cannot be viewed as a firmly defined set of rules but rather constitute a tool to delimit the taxing authority of states according to what they consider appropriate to avoid double taxation and in a way which is closely attuned to the particular pattern of their economic relations.

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After passing the examinations to be admitted to full judicial office in the Federal Republic of Germany (grosse juristische Staatsprüfung), he entered the German Revenue Service in 1955. He became "Ministerial-dirigent" and was Head of the Division dealing with tax treaties and international taxation.

In the fall of 1974 he left the German Government service to take up an appointment with the United Nations where he became Under-Secretary-General heading, among other things, the financial department.

In 1983 Dr. Debatin returned to the Federal Republic of Germany where he became a full professor in international financial and tax law at the University of Hamburg.

In August 1984 he was admitted to the New York bar as an attorney at law and in November 1984 he qualified as a tax consultant (Steuerberater) in the Federal Republic of Germany.

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[1] In German tax literature a distinction is made between the concept of "tax subject" (i.e. the taxpayer) and the concept of "tax object" (i.e. the income, net wealth, turnover etc. subject to tax).

3. Delineation of taxation by the concept of permanent establishment

All international tax treaties use the concept of "permanent establishment" and consequently define what, under their provisions, is to be classified as such an establishment. A promising achievement of international tax law appears to be the development of a more or less uniform definition of permanent establishment in tax treaties. However, as much as this approach tends to facilitate a uniform implementation of tax treaties, the concept of permanent establishment economically carries quite different dimensions. It determines, in respect of economic activities extending from one country into the other, whether and to what extent they remain subject to tax in the latter country. States, therefore, are not in a position to decide on the basis of a conceptual approach, but rather, what is essentially at stake is a mutual adjustment of their divergent economic interests. Analysis under this aspect of the approximately 50 German tax treaties indicates quite clearly this phenomenon and the reasons behind the different definitions of permanent establishment in various treaties: The more a country is in a debtor position vis-à-vis the Federal Republic of Germany, the more it will insist on a broad definition of the term "permanent establishment" so as to maintain, to the broadest extent possible, taxation of German activities carried on in its territory.

4. Purpose of tax treaties

These few observations demonstrate that tax treaties between states are not to be viewed as an end in themselves but rather derive their justification and purpose from the goal to place their mutual economic relationships under an adequate tax protection guaranteed by international law. Of course, the requirements differ from state to state, but they present a challenge to every state striving to extend its economic activities beyond its own borders and in turn desiring to attract foreign economic engagement to its own territory!

II. THE SITUATION OF STATES OF THE "SOCIALIST" ECONOMIC ORDER

1. OECD Model Convention

States having a "socialist" economy are faced with no different challenges than other internationally engaged countries. Unfortunately however, they initially refrained from sharing in the international endeavors to develop new future orientated treaty concepts. In the 1950s this task was taken up by the OEEC (Organisation for European Economic Cooperation) following up on the former work of the League of Nations in the field, and later the OECD (Organisation for Economic Cooperation and Development) continued in the pursuance of this effort. As a result in 1963 a comprehensive Model Convention was published which, after careful revision, resulted in the 1977 Model Convention. Although not constituting a treaty between states but rather a treaty model only whose provisions were merely recommended for incorporation into bilateral tax treaties, the OECD proposals, understandably, were initially confined to the treaty practice between OECD member states. Later on, however, these states adopted the model structure and, to a lesser extent, its substantive solutions in their tax treaties with developing countries. The "socialist" countries still stood aside but this situation has since changed. As soon as these countries entered into the conclusion of tax treaties with "western" countries (today the Federal Republic of Germany has tax treaties with the Soviet Union, Poland, Romania and Hungary) these treaties were in form and content greatly influenced by the OECD Model.

2. Credit method or exemption method

The resumption of treaty practice by countries of the "socialist" economic order only reactivated the heritage of earlier days when, due to close inter-state economic interdependence, tax treaties took root in Europe, involving, particularly, the eastern European countries. The driving forces behind this treaty activity in continental Europe contrasted with the Anglo-Saxon practice focusing particularly on relations with overseas territories. From this, differences in approach still exist today, particularly with regard to the central issue of the method for the avoidance of double taxation, e.g. in what manner the state of the taxpayer's residence is supposed to recognize the taxing right preserved by the other state. Based on the idea that the tax burden ultimately be determined by the tax level in the taxpayer's home country, the Anglo-Saxon tax tradition follows, for the avoidance of double taxation, the so-called "tax credit method" by which foreign tax is credited against domestic tax. By contrast, the practice of the continental European countries was formed by the concept of allocating "taxable items" between the contracting states, with the result that items of income of property which one contracting state was allowed to continue to tax were exempted from tax in the other state. This system, labeled as the "exemption method", is particularly significant in relation to states of the "socialist" economic order, since their system of public levies – as clearly seen in the case of state enterprises – cannot readily be equated with taxes of the type imposed in capitalistic countries; hence, the tax credit method – if applied at all – can only be used with special modifications.

3. Compatibility of tax relief method with "socialist" countries

The OECD Model Convention permits the contracting states to choose between the two aforementioned methods – e.g. the "tax credit method" or the "exemption method" – and therefore does not, with regard to this basic issue, create an obstacle for states of the "socialist" economic order. Besides, the solutions proposed by the OECD Model Convention are very much in line with the protectionist interests of socialist states, and even particularly fit their expectations. Whilst the most significant feature of the OECD Model Convention is to restrict as much as possible taxation in the state of source – which, incidentally is the basic source of conflict with the treaty concepts of developing countries – the tax treaty policy of the states of the "socialist" economic order adapt fully to the OECD approach, sometimes pushing its tendencies even further. This is evidence that, under today's understanding, tax treaties do not stop at merely avoiding double taxation but, with a far broader view, are designed to form a bridge between different tax systems so as to reduce frictions and distortions existing between them.

III. TAX TREATIES' SCOPE OF PROTECTION

1. "Western" type enterprises

As a starting point every tax treaty has to determine its personal scope of application, e.g. who shall be entitled to treaty protection. Covered are, viewed from a state's position, individuals resident in its territory, and – according to the definition used in the OECD Model Convention – juridical persons and other entities which are treated as a body corporate for tax purposes. Evidently this description is tailored towards Western-type tax systems. If an economic association lacks the qualification of a taxable unit of its own, it will not receive tax treaty protection but will rather be considered a conglomeration of interests where each individual participant separately holds the right to treaty protection.

2. "Socialist" type enterprises

The economic systems of Eastern European states have created types of enterprises which do not readily fit into this customary scheme. This is evident from the fact that there exist no enterprises of a Western type but only state enterprises or enterprises dependent on the state. Furthermore, there are types of associations which, purposely, are not accorded legal independence, but rather are kept in the form of joint interest associations of a "socialist" type. In these cases the classification for tax treaty purposes – or, to be more precise, the personal allocation of tax treaty protection – creates difficult problems, complex to a point, and it is because of this issue that the Federal Republic and Yugoslavia have not, despite many years of negotiations, yet reached an agreement.

3. "Mixed" enterprises

Different, again, is the situation for those states of the "socialist" economic order which permit participation in domestic entities by enterprises from the West. This kind of economic cooperation has gained prominence under the term "mixed enterprises". On the one hand, these enterprises remain rooted in the socialist economic environment but, on the other hand, must offer their foreign participants a scheme of profit making which requires adequate tax adjustments for the profit distribution flowing to them. Notwithstanding these difficulties "mixed enterprises" have found a firm place in international tax treaty law. This illustrates that tax treaties must offer extensive protection to cover all taxpaying units of a treaty country irrespective of how they are organized under the national legislation concerned.

IV. NECESSITY AND STRUCTURE OF TAX TREATIES

1. Similarity in tax systems

Taking as an example a person entitled to treaty protection who derives income from the other treaty state, the basic object of the tax treaty is to prevent double taxation caused by the fact that the taxpayer is subject to tax in the country from which the income is derived as well as in his home country. The taxation in the state in which the income is generated – briefly designated as "source taxation" – basically addresses the income as such rather than the person of the taxpayer and consequently relies on an extensive use of withholding taxes at source. The state in which the recipient of the income is resident – designated as the "country of residence" – is expected to grant adjustment for the foreign tax at source which – similar to the technique used in respect of domestic advance tax payments – is most appropriately done by crediting the foreign tax against the domestic tax. This procedure, however, requires for its satisfactory implementation that the tax of the source country and the tax of the country of residence are more or less of an identical nature which, in relation to states of the "socialist" economic order, is only valid to a limited extent. Moreover, the tax credit system suffers from the disadvantage that it does not always ensure complete elimination of double taxation. A simple example illustrating this problem is the case where the tax imposed in the source country – which is levied on the gross amount – exceeds the tax in the country of residence, imposed on the lower level of net income. Therefore, a satisfactory solution can only be found if both states are prepared to limit their taxing authority – for which tax treaties provide the basis and frame.

2. Dissimilarity in tax systems

Unfortunately, only in recent times did the states of the "socialist" economic order come forward with their contribution to the development and refinement of tax treaty law, despite the significance such contribution would have made due to those states' longstanding experience. Apparently, for quite some time doubts prevailed as to whether there existed a sufficiently common ground in view of the differences in the tax systems and also in light of the standard double taxation formula that the taxes in both states must be of an identical or at least similar nature.

However, the tax treaty practice of the Western states indicated that in the long run this would not constitute an obstacle since even their taxation systems are far from identical. Some of these countries even impose taxes which do not exist in other countries, such as the German concepts of net wealth tax and business tax (Gewerbesteuer).

3. The "general approach" to tax treaties

Whereas in the past taxes not imposed in both contracting states were, due to lack of reciprocity, excluded from tax treaty protection, it is now commonly accepted to waive the requirement of similarity of the individual types of taxes imposed in one and the other contracting state, and rather to focus in a kind of comprehensive approach on the total burden of direct taxes. Thus tax treaties gradually developed from their initial object of removing double imposition of similar taxes into a tool regulating the tax conditions for international economic competition. They now delimit the tax jurisdictions of contracting states in regard of the total tax burden which they impose via direct taxes on international business and investment activities. This approach has greatly assisted in making double taxation treaties also attractive to countries of the "socialist" economic order: For they are now in a position to include their profit levies into the adjustment mechanism of such tax treaties, although such levies are not fully comparable to taxes in Western fiscal systems. Even in the public finance sciences' discussions in the East, doubts are raised whether such levies fulfill the essential characteristics of a tax as they do not involve a transfer of money title from the taxpayer to the state.

4. Tax treaties as bridges between different tax systems

Summarizing the above, it clearly appears that the conclusion of tax treaties between Western industrial states and the states of the Eastern economic system is a fundamental requirement in our modern world. Only by doing so can countries meet the challenge to further worldwide economic advancement across their different economic systems by enhancing the international exchange of goods and services and inter-state mutual cooperation. A significant example of this new development is given by the Soviet Union which, while not permitting foreign participation in their enterprises, has nevertheless concluded tax treaties with Western countries in order to provide a firm umbrella of tax protection favoring the country's economic interchange with other nations. Thus, tax treaties – extending far beyond their original scope – have developed into bridges between tax systems of even extreme divergency – and the greater such divergency, the higher the value to be attributed to such a treaty.

V. TAX ADJUSTMENTS THROUGH TREATIES

1. Adjustments to minimize revenue loss

Tax treaties focus on delimitating for the taxpayers in the one contracting state their taxation at source in the other state. By limiting the scope of taxation in the latter country, a corresponding tax relief is produced. However, it should be observed that tax treaties affect the contracting states in a reciprocal manner, as each of them is country of source for taxpayers resident in the other country. However, such equivalence in the treaty application does not entail equivalence in their fiscal sacrifice: For the magnitude of revenue loss to be shouldered by a contracting state by a reduction of its taxation at source depends upon the balance of payment in relation to the other state. For instance, if the treaty provides that royalties be exempted from tax in the country of source, the treaty country which is predominantly in a debtor position vis-à-vis the other will suffer the greater tax loss. This naturally dampens the willingness of such a state to agree to a reduction of its source taxation, which then will result in a treaty arrangement which – in its abstract terms – maintains taxation at source at a correspondingly high level. In contrast, if the exchange of goods and services between the two states is more or less even, this will lead to the tendency of abolishing source taxation, as the resulting revenue loss is about equally shared by the contracting states. This explains why the OECD Model Convention proffered by the Western industrial states is characterised by a reduction, as extensive as possible, of taxation in the source state. Conversely, it indicates why tax treaties between industrial countries and developing countries adhere, as much as possible, to source taxation since any relief therefrom burdens, in a one-sided fashion, the country in the predominant debtor position, e.g. the developing country. The more a tax treaty between an industrial country and a developing country reduces source taxation, the greater the tendency that the developing country will bear the revenue sacrifice.

2. The aspect of tax loss in treaties with "socialist" countries

What kind of tax loss is suffered by states of the "socialist" economic order when they conclude a tax treaty? With respect to export activities, their strength lies – at least up to the present – in the area of construction activities. They possess the equipment, capacity, know-how and personnel to engage in foreign construction projects which offer them a profitable source of foreign currency. Using the test of the OECD Model Convention, construction or installation projects constitute a permanent establishment if they last for more than 12 months and conversely, taxation in the country of such activity is abolished if the project remains within the 12-month time span. Developing countries which are predominantly host countries for construction and assembly projects reject the above rule as being too liberal and, in view of the resulting revenue loss, are prepared to waive – supported by the proposal of the UN Model – their right of source taxaticn only where the construction or installation project does not exceed 6 months – in some agreements even a shorter period. The states of the "socialist" economic order take just the opposite view. They wish to see taxation in the source state even more restricted than suggested in the

OECD Model Convention. According to their view, the time span within which a permanent establishment is denied should be further extended in order to achieve a correspondingly enlarged exemption from tax in the country where the activity is undertaken. This suggestion has found recognition to some extent in the tax treaties concluded by Eastern European states. For instance, the tax treaties of the Federal Republic of Germany with Poland and Romania provide that (although limited to a transitional period of 5 years) a construction or assembly project shall not be considered a permanent establishment as long as it does not exceed 18 months; consequently German taxation is cancelled if the project lasts only a shorter period of time. However, it should not be overlooked that this deviation from the OECD proposal has been repeatedly criticized as a violation of competitive tax neutrality within the German construction market.

3. Adjustments concerning the treatment of construction personnel

Closely connected with the definition of permanent establishment as applied to construction or assembly projects is, of course, the treatment of the construction personnel. The treaties do not – which should be kept in mind – deal with the case of construction workers who leave their home country and take exclusive residence in the country where the construction or assembly activity is undertaken. In that instance they become, for tax purposes, resident in the latter country and consequently are subjected to tax therein – like all other resident employees – on their employment income. Under consideration here is the case of an employee, let's say in Poland or Romania, who only comes to the Federal Republic of Germany – being the treaty partner state – for the purpose of working on the construction site. The OECD Model Convention is based on the assumption that the state in which the construction or assembly activity takes place, once it grants tax exemption for the profits derived therefrom, should extend such relief to the wages of the construction personnel as well. The argument is that otherwise, as such wages reduce the profit of the construction project, the tax exemption thereby granted might be – at least in part – recouped "through the back door" by taxing the wages. Tax treaty partners in Eastern Europe therefore successfully insisted that as long as a construction or assembly activity is exempted from tax in the host country, the personnel attached to such project should also enjoy tax exemption for their salaries.

4. Choice of method of avoiding double taxation by the state of residence

Under tax treaty standards the tax treatment applied in the country of residence of the taxpayer is basically irrelevant, as long as it provides, for the purpose of avoiding double taxation, an adjustment for the tax maintained in the other state. How this is achieved, i.e. technically, which method for the avoidance of double taxation is to be adopted in the country of residence, is left to the choice of that state. Countries of the "socialist" economic order will, for a variety of reasons, prefer to eliminate double taxation by the exemption method rather than by the tax credit approach.

5. Effects on "Western" treaty country

Examining now the opposite case of an enterprise established in a Western treaty country carrying on activities in a socialist state the reverse effect of a broad exemption from tax in the source country comes to bear. As long as the construction or assembly activity undertaken in an Eastern host country does not create a permanent establishment, that country must grant tax exemption leaving taxation exclusively to the Western home country of the enterprise. In contrast, if the time requirement for assuming a permanent establishment has been fulfilled, the entrepreneur will be exempted from tax in his home country, subject however to the so-called "progression rule" according to which the exempted income must be included in the tax base for the purpose of determining the applicable income tax rate for the remaining income.

VI. INVESTMENTS AND TAX TREATIES

1. Foreign investment through "mixed" companies

Western entrepreneurs might consider it particularly attractive to do business in a socialist country by way of participation in a domestic enterprise. Outstanding examples of such a scheme are the so-called "mixed companies". They provide the organizational framework to engage in entrepreneurial cooperation with entities in socialist countries – which naturally requires adequate tax adjustments to the exigencies of such joint ventures. In Eastern European states the process of development in this area is still under way. For instance, the Soviet Union under its legal and economic system does not permit foreign participation in domestic enterprises, whereas other states of the socialist economic order even welcome such engagement from abroad, provided however, that predominant domestic influence is preserved. In these instances taxation must be designed so as to adequately reconcile the system of levies in a "planned economy" with the Western concept of taxation. In this regard the creation of "mixed" companies marks an outstanding pioneer effort. These enterprises remain firmly embedded in the "planned economy" system as an integral part of the state's economy as a whole, yet at the same time, adequate leeway is offered for economic arrangements reflecting "capitalistic" thinking.

2. Treatment of royalties, interest and dividends by "Western" countries

Attention is to be given to the fact that tax treaties traditionally rely on income classifications presenting, from the viewpoint of Eastern countries, rather difficult problems of reconciliation. Thus, tax treaties generally distinguish between dividends, interest and royalties, which has only a limited parallel in the taxing pattern of socialist states. Moreover, tax treaties do not provide for a uniform treatment of these items of income.

Dividends are understood to consist of profit distributions by independent companies, whose taxation is not affected by the treaty application; however, as soon as such a company, being resident in one treaty state, makes a profit distribution to a shareholder in the other treaty state the beneficiary receives dividend income which, following the general pattern of tax treaties, may be taxed in the source state, only up to a maximum rate of 15%. The source country is not required to impose tax up to that ceiling but may satisfy itself with a lower rate of tax or may even waive tax altogether.

With respect to interest, industrial states connected by an evenly balanced economic relationship are regularly prepared to waive taxation at source whereas, by contrast, developing countries, in view of their debtor position, naturally insist on keeping source taxation at a rate as high as possible.

As regards royalties, the situation is similar to that of interest although the need for the transfer of technical know-how might suggest – ass proposed in the OECD Model Convention – the waiver of taxation at source.

3. "Socialist" countries and the tax credit method

In order to properly understand the tax treaty mechanism, it should be kept in mind that income from dividends, interest or royalties is also subject to tax in the country where the shareholder, lender or licensor, respectively, resides. According to the OECD proposal, for the purpose of elimination of double taxation, the tax imposed in the source state is to be credited against this tax. As a result – provided that the state of residence does not grant further tax relief – the tax burden is, at a minimum, maintained at the level corresponding to the tax legislation in the residence state. However, countries of the "socialist" economic order have, because of their particular tax system, only little use for the tax credit procedure. They often let foreign-source income go untaxed or they apply simpler methods of tax relief than the tax credit method which is, indeed, relatively difficult to administer.

4. Treatment of royalties by "socialist" countries

The aforementioned difficulties might additionally lend support to the approach of completely waiving taxation at source, a solution which, particularly as regards royalties, reflects a well-considered economic policy – is often found in the tax treaties of socialist countries. By this approach these states are enabled to license, in addition to copyrights, industrial property rights and technical know-how to licensees in the West without having earned profits in hard currency being cut by foreign taxation at source. On the other hand, Western licensors are assured that the granting of licenses to licensees in Eastern states will not be hampered by taxation at source which regularly is imposed on the gross amount paid and therefore can, in the state of residence of the licensor where he is subjected to tax on his net income only, often not be fully absorbed by way of the traditional tax credit method. The concern, from the point of view of a state that, due to the waiver of taxation at source, too much would be paid abroad in terms of royalties is, for "socialist" states, hardly relevant as they subject all license contracts with foreigners to governmental control. Thus, they are able to attain the desired level of license fees far more effectively than by the mechanism of taxation at source.

5. Treatment of interest by "socialist" countries

The situation with respect to interest is not much different from that of royalties but in addition, in relation to socialist countries, loan financing in the private sector is only of minor significance as compared to that in the public sector. As the OECD Model Convention permits the imposition of tax at source on interest up to a maximum rate of 10% which, between industrial states, is regularly waived in favor of exemption, socialist countries can readily adhere to the OECD approach, at least by not advocating a higher rate of tax at source. Actually, their tax treaty practice very often settles on a lower ceiling rate than in the OECD Model and, in addition, extensive relief from source tax is granted for loans in the "public sector". Since in these countries loans from abroad require governmental approval the imposition of a domestic tax at source on interest is, from their viewpoint, only of limited significance; rather they might prefer to have source taxation removed as this would benefit them by having their foreign interest income exempt from foreign taxes at source.

6. Treatment of dividends by "socialist" countries

Finally as regards dividends, these constitute income from participations in "capital companies" ("Kapitalgesellschaften" or "sociétés de capitaux").[2]

This organizational form, attuned to the free market system, is essentially alien to planned economies. Nevertheless, the "socialist" states have acquiesced in the idea – although to rather diversified degrees – that their state enterprises may accept capital contributions from investors in the West to whom an adequate share in profits is to be allocated – which takes the form of a dividend income in the hands of the recipient.

The classification of income for tax purposes in this field is, however, in many respects not yet fully clarified. This is because the participation of enterprises of "capitalist" countries in qualifying ventures in states of the "socialist" economic order often takes the

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[2] "Capital companies" is a typical continental law concept. It denotes a company form which basically relies on accumulated capital. The participants are shareholders, whose position is far weaker than that of a partner in a partnership. Examples are the German "Aktiengesellschaft" and the French "société anonyme".

form of a "package deal". Regularly the actual capital participation is coupled with the provision of loan capital and, particularly, the furnishing of technical assistance which, under the overriding goal of a well functioning extended international cooperation, makes immensely good sense. However, from a tax point of view, the question arises as to how, in such a situation, the income is to be dissected into its various components. Take as an example a cooperation contract under which capital as well as equipment is furnished and, in addition, patents are licensed and technical assistance is supplied.

Which slice of income is to be allocated to each of these elements? Up to now the momentum of the enormous upswing in economic cooperation between "capitalist" and "socialist" countries has prevented many of these problems from coming out into the open, but sooner or later they will require clarification.

7. The "affiliation privilege"

Finally, under the aspect of international entrepreneurial cooperation, it is of crucial importance what tax reliefs Western countries grant their entrepreneurs for their engagements in states of the "socialist" economic order. As pointed out, these countries, in their position as state of residence, basically insist on full taxation of inflowing dividends, interest payments and royalties, thus denying any tax relief or tax incentive. However, there is a far-reaching, and indeed crucial, exception to this approach. It is for historical reasons labeled "affiliation privilege". However, this is a misleading denomination, since it does not actually convey a "privilege". The basic idea is rather that an enterprise holding a substantial capital participation in another independent enterprise becomes economically interconnected with it in such a manner that it appears justified to treat both enterprises as one economic unit. This brings into focus the tax treatment of an enterprise with respect to its dependent branch offices, i.e. permanent establishments abroad. Such an enterprise, as previously explained in connection with the treatment of construction and assembly projects, is exempt from domestic tax on the profits of its foreign permanent establishment.

Taking it from there, tax exemption is also granted for distributed profits, e.g. dividends, derived from participation in foreign companies, provided that such participation is so substantial that it is, as distinct from a mere financial investment, of an "entrepreneurial character". As a corollary to the approach of viewing the tax incidence by its total impact, tax exemption is also granted from capital taxation of the shareholding participation as such.

The "affiliation privilege", as included in tax treaties with states of "socialist" economic order, provides a powerful tax incentive for the acquisition of participations in enterprises in such states. However, whether and to what extent such incentive comes to bear depends upon the readiness of "socialist" states to allow such participations from the Western hemisphere – and, as already stated, in that respect "socialist" countries offer a surprisingly wide spectrum of approaches.

VII. OUTLOOK

The treaty policy of states of the "socialist" economic order has, from its inception, adhered to the principle of reciprocity. This approach has not only smoothed the way to the conclusion of tax treaties, but also conveys the spirit of true partnership. Against this background tax treaties are to be understood as both a confirmation of, and a challenge to, fruitful international economic cooperation!

Collaboration Agreements – Some Issues

By M.B. Rao

Dr. M.B. Rao, who is currently a member of the Law Commission of India, completed his law studies in 1948 at Madras University in India. He was awarded an LL.M. in revenue and company law at the University of London in 1970 and received a Ph.D. in international economic law and double taxation in 1981 at Delhi University. He has done extensive research work, among other things, in contract law (including mercantile law) at Madras University during 1948-50 and in international economic law and double taxation at the Academy of International Law in The Hague (the Netherlands). Dr. Rao has filled a great many Government posts and in 1974-75 and again in 1983 he acted as a tax law expert for the United Nations in Trinidad and Tobago. He has also participated in a number of conferences: he was a member of the Indian delegation for Eurodollar loan negotiations in Hong Kong (1977), he led the Indian delegation to the United Nations conferences on international trade law in New York (July-August 1977) and he was a member of an Indian delegation for the conclusion of an agreement between India and the Federal Republic of Germany (1980).

Collaboration agreements and payments for know-how are among the economic consequences resulting from the financial order as it emerged after World War II. Collaboration agreements encompass distinct subjects, such as the establishment or setting up of a factory or industrial unit, on which the foreign collaborator and a local concern in a developing country seek to mutually cooperate. A collaboration agreement may also provide for the running of a factory. Some of the aspects therein include provisions for assignment of, or licences for, working patents, the training of technical personnel and sharing results of research and development. Although it is common to find all these aspects of aid by the foreign collaborator to the local concern in a collaboration agreement, the consideration provided for in such agreements may take different forms. Some may contain a composite payment for the supply of plant and rendering of services while others may provide a separate consideration specifically for each and every aspect of collaboration.

Even though nations differ as to what degree tax plays an important rôle in any given investment decision, yet taxation can change the order of choice for rational investment. If an investment decision is to be taken, it would be more tempting to take advantage of the generous subsidies plus tax exemptions on exports (apart from tax holidays etc.) offered by host countries to attract capital from abroad, than to invest in a country which does not offer such attractive incentives for investment.

If there were no taxes in any nations of the world, and if there were freedom and stability in currency exchange, it would be of little importance to a foreign enterprise, a multinational corporation or to a Government where a multinational enterprise's profits accrued. The incentive to arrange transactions among different countries for tax advantages would be removed if all income tax systems where identical, or if related corporations were taxed as parts of the same entity and subject to world-wide taxation. But such is not the reality and will not be in the foreseeable future. Nor is the attempt for international tax harmonisation going to yield results in the immediate future.

The foreign investor in such a case has to deal with at least two tax authorities, those in his country of residence and those in the host country where foreign investment is to be made. The prospect of double taxation poses a very serious threat to an international investor. National taxing systems can be classified and sub-classified in many different ways. There are differences in types of taxes, rates, definitions of income and expenses, extra-territorial jurisdictional principles and allowances for foreign taxes paid. Different countries imposing direct taxes may impose income tax on different basis. In the U.S.A., for example, the place of incorporation generally determines the tax jurisdiction. The U.S. Government claims the right to tax income of a corporation arising outside its borders if that income is received by a corporation incorporated or domiciled within the U.S. The general European attitude is that corporate profits should be taxed in the source country where the profits are generated and the management and control is located. In the Federal Republic of Germany, a company is taxed on its world wide income, unless specifically exempted, if it is resident in the Federal Republic, i.e. if its centre of control lies within the Federal Republic.[1] In the U.K., however, the place of management governs the taxability of the unit.[2] In India, a company is said to be resident and as such, taxable, if it is an Indian company or the control and management of its affairs is situated wholly in India.[3]

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[1] The Impact of Multinational Corporations on Development and on International Relations – Technical papers – Taxation, U.N. document ST/ESA/11, page 9 and 13.

[2] Cesena Sulphur Co. vs. Nicholson (1876). 1 Ex.D. 428. See also De Beers Consolidated Mines Ltd. vs. Howe 5 T.C. 98 (H.L.) and Bullock vs. Unit Construction Co. Ltd. 38 T.C. 712 (H.L.).

[3] See 6 Income Tax Act, 1961.

For a foreign enterprise, double taxation enters into play when the home country (i.e. the country where the company is established) taxes foreign-source income under a world-wide tax policy. Where such double taxation occurs and where the host country and the home country have different rates or principles of taxation, the foreign enterprise must compete with enterprises in the host countries under tax conditions which differ from those applicable to the latter. Although most countries presently follow the territorial or source principle, there is a trend in the direction of world-wide taxation of profits by the home country, at least when these profits are repatriated.

International double taxation is generally avoided by several mechanisms. The traditional methods are by grant of tax credit or exemption of foreign income. Other measures of a more limited consequence are application of reduced tax rates to certain types of foreign source income and various kinds of investment allowances and investment credits. Some countries recognise the fact of foreign taxation merely by permitting their taxpayers to deduct foreign income taxes in the same manner as other items of cost and expenses.[4] Such relief is either unilateral under national law or by way of a bilateral tax treaty with the host country.

Exemption of foreign income by statute is, as a rule, confined to profits from a permanent establishment, income from real property situated abroad and foreign dividends received by domestic corporations. Under this system profit is taxed in only one of the countries concerned and is exempted from tax in the other. France, the Netherlands and Switzerland do not tax profits of a foreign permanent establishment. Canada, the Netherlands and Switzerland also exempt dividends from foreign subsidiaries under certain conditions.[5]

Exemption by treaty of certain foreign-source income is widely applied by the Scandinavian countries. The tax concessions thus granted by the country of source are not reduced or eliminated by the investor's home country.

In contrast to the above, the foreign tax credit system envisages that tax paid in another country is allowed as a credit against tax liability in the home country. The U.S.A. and other capital exporting countries adopt this system. It is common knowledge that most of the developing countries use tax incentives on a very liberal scale to attract foreign private investment. While some of the capital exporting countries in Europe have concluded tax sparing credit provisions, i.e. giving credit not only for tax paid but also for tax spared by the developing country by grant of tax incentives, the U.S.A., in contrast, grants tax credit only in respect of taxes actually paid abroad. The U.S. point of view appears to be that tax sparing violates the principle of tax equity in the investor's country, which envisages that the burden of tax should be the same whether invested in the investor's country or outside of it. If such equity is insisted upon, the result is that tax revenue may be transferred to the investor's country of residence from the country where the investment is made because the effective tax rate is generally less in the developing country as a result of tax incentives offered by that country to attract foreign investment.

The developing countries' point of view that tax credit should also be extended to the tax spared is fully reflected in the discussions of the Ad Hoc Group of Experts appointed by the U.N. Secretary-General to draft a model tax treaty between developing and developed countries (in pursuance of the resolution of the U.N. Social and Economic Council).[6] While Japan and many countries in Europe recognise that tax spared should be given credit, certain other countries, such as the U.S.A., insist on tax equity amongst their investors and will not grant credit to the tax spared by the host countries.

For a detailed discussion on the necessity for tax sparing credit, see the author's book: "Double Taxation between Developing and Developed Countries", (1983 – Milind Publications, 6E, Rani Jhansi Road, New Delhi).

That tax sparing should be taken into account, as otherwise it would result in an unintended situation, may be illustrated as follows: In India, a study into the financial workings of some of the large industrial companies on a selective basis disclosed that none of these companies were paying tax after availing themselves of the tax incentives. As a result of the study, the Income Tax Act was amended by the Finance Act, 1983, whereby 30% of the profits of such companies were made liable to income tax. If the U.S.A. in a tax treaty with India were not to grant tax credit in respect of tax spared, the result would be that U.S. companies operating in India, instead of paying tax to India, would pay tax spared by India to its country of residence, the U.S.A. To put it another way, it is aid in the reverse direction, i.e., from the developing country to the developed country, which is, obviously, wholly unintended.

The U.S. Government which has expressed its unstinted support to developing countries in every way should, therefore, examine the situation afresh and see its way, additionally, to granting tax spared in its tax treaties with the developing countries.

This aspect of international double taxation was discussed at length because, in any foreign collaboration agreement, double taxation will have to be recognised and a suitable effort made to overcome it, as otherwise it will act as a positive disincentive to the foreign investor in making an investment decision abroad. The need for international tax harmonisation or, at any rate, the need for double tax treaties between the developing and de-

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[4] Tax Treaties between Developed and Developing countries, Part II, Paragraph 7, U.N. Document E/4614/ST/ESA/110.

[5] Ibid., paragraph 8.

[6] U.N. document of Economic and Social Affairs, Tax Treaties between Developed and Developing Countries. First report, U.N. document ST/ECA/10 (1969) paragraph 103; Fourth report, U.N. document ST/ECA/188 (1974) paragraph 179; and Guidelines for tax treaties between Developed and Developing countries, U.N. document ST/ESA/114 (1974), p. 12, paragraph 54.

veloped countries on a much larger scale than exists at present must be emphasised, so that such a positive disincentive in making an investment decision with a developing country is nullified. Tax treaties can also solve many other double taxation problems, for example, by reconciling differences in the concepts of various types of income and their geographical source and either assigning exclusive tax jurisdiction over certain income to one of the treaty countries or dividing the revenue between the two Governments where neither is willing to relinquish its full claim. Additional benefits of a tax treaty are exchange of information and procedures for mutual assistance between the contracting countries as well as the benefits derived from the customary non-discrimination clause on treatment of foreign investors and nationals in the host country.

The first question, therefore, that a foreign collaborator should determine before finalising any collaboration agreement is the existence of a tax treaty with the host country for avoidance of double taxation. He thereby knows how his income in the source country is subject to international double taxation, if any, and whether he will be given credit for tax paid as well as for the tax spared in the host country.

The next question the foreign collaborator should examine is the tax consequences of receipts in his hands arising out of a collaboration agreement. He should determine to what degree receipts in the hands of a foreign collaborator and conversely payments by the local concern are subjected to tax under the national tax law. Some of the receipts in the hands of a foreign collaborator may be capital receipts not liable to tax, while others may be revenue receipts. Conversely, some of the payments by the local concern may be capital expenditure while others may be revenue expenditure. Whether a particular receipt is a capital receipt or an income receipt and correspondingly whether a payment is a capital or a revenue expenditure depends on the facts and circumstances of the case, i.e. on the aim and object of the expenditure, the type of business of the foreign collaborator, whether he has parted with an asset or the asset is a stock-in-trade which he uses as a trader, or conversely whether the local concern acquired an asset or has only incurred an expenditure of a revenue nature in the running of the factory or business.

In British Insulated and Helsby Cables Limited vs. Atherton,[7] a classic decision and the leading case on the subject, Viscount Cave observed that a payment made 'once and for all' to bring into existence an asset or an advantage as an enduring benefit is a capital expenditure. However, Viscount Cave cautioned that the fact that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur once each year is not a decisive test in every case. Lord Atkinson in the same case indicated that the word 'asset' ought not to be confined to 'something material'. Generally, it may be stated that if the payment is for acquisition of an asset or to dispose of an item of fixed capital that is of an onerous character, it is a payment of a capital nature. On the other hand, if the payment is not for the acquisition of an asset or of an enduring benefit, but only is of an incidental nature of earn more profits, it probably is a case of revenue expenditure.

There is an abundance of case law to distinguish capital expenditure from revenue expenditure and conversely capital receipt from income receipt in the hands of a foreign collaborator. Whether a particular expenditure is a capital expenditure or a revenue expenditure is rather a difficult question. There have been numerous decisions where this question has been considered and it is not always easy to reconcile the reasoning given therein in support of the conclusions. Many cases fall on the border line. The Supreme Court of India in the well-known case of Empire Jute Co. Ltd. vs. CIT[8] laid down the following propositions:

(i) It is not a universally true proposition that what may be a capital receipt in the hands of the payee must necessarily be capital expenditure in relation to the payer. The fact that a certain payment constitutes income or capital receipt in the hands of the recipients is not material in determining whether the payment is revenue or capital disbursement qua the payer.

(ii) There may be cases where expenditure, even if incurred for obtaining an advantage of enduring benefit, may, nonetheless, be on revenue account and the test of enduring benefit may break down. It is not that every advantage of enduring nature acquired by an assessee that brings the case within the principle laid down in this test. What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable (in computing profits) on an application of this test (words in brackets supplied). If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account even though the advantage may endure for an indefinite nature. The test of enduring benefit, is, therefore, not a certain or conclusive test and it cannot be applied blindly and mechanically without regard to the particular facts and circumstances of a given case.

(iii) What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process. The question must be viewed in the larger context of business necessity or expediency.[9]

The difference between a capital receipt and an income receipt, as also between capital and revenue expenditure, is important when, under the terms of the agreement, the foreign collaborator establishes a factory, assists in running that factory, assigns patents, provides for licences for working of the patents or shares the results of the research and development conducted in his laboratories in his country of residence. In all these

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[7] (1926) A.C. 205.

[8] (1980) 124 ITR. 1. (SC).

[9] These were summarised in the Headnote at p. 2 and 3. *ibid.*

cases, the nature of the receipts in his hands may well determine the quantum of consideration therefor, as it is likely that such consideration would be negotiated based on whether the payments were taxable in his hands or not. Similarly, when a local concern seeks to import the plant and machinery or enters into an agreement for licensing arrangements for working the patents, etc., the nature of the payments in his hands will have to be taken into account as the consideration therefor may vary depending on the tax consequences on such payments. In any case, when the amount paid is in the nature of capital expenditure, it is advantageous for the local concern to ensure that as large an amount as possible is considered as the cost of the 'plant', so as to claim the investment allowance, depreciation/development rebate etc., normally allowed under the national tax law as incentives for investment in new projects.

Having taken into account the difference between capital and revenue expenditure as well as capital receipt and revenue receipt, an inter-related problem is the nature of the 'know-how' imparted under a foreign collaboration agreement because if the receipt therefor is also a capital receipt, it is not liable to tax in the source country. Another point that comes up for consideration in determining whether the payment becomes taxable in the country of residence of the importer is: where is the contract entered into and where is the payment made for the import of plant and machinery or 'know-how'? Taking the simplest case of purchase of plant and machinery abroad and payment made abroad, any income or profit arising therefrom is not liable to tax, as the purchase and payment are outside the taxable territories. If, however, apart from supply of plant, the foreign collaborator undertakes to set up the plant, supply the 'know-how' or provide for personnel to run it, then the latter activities, taking place in the taxable territories, may be subjected to tax. Another important point that should be considered at this stage is: does the income accrue or arise to the foreign collaborator from any "business connection"? It is quite usual to find provisions in the tax laws of developing countries, like India, wherein such income is deemed to have accrued or arisen in these countries.

Now, coming to the nature of 'know-how', it consists of all the undivulged technical information, whether capable of being patented or not, that is necessary for industrial reproduction of product or process, directly and under like conditions. Inasmuch as it is derived from experience, 'know-how' represents what a manufacturer cannot know from a mere examination of the product and mere knowledge of the technical process. In a 'know-how' contract one of the parties agrees to impart the special knowledge and experience which remain concealed from the public to the other so that the latter can use it for his own purposes.

The House of Lords in Musker vs. English Electric Supply Co. Ltd.[10] observed that special knowledge and skill can indeed ripen into a form of property in the fields of commerce and industry, as in copyrights, trade marks, designs and patents, and where such property is acquired for money, what is received can be, but will not necessarily be, a receipt on capital account. It is, therefore, necessary to examine in what capacity the foreign collaborator imparted the 'know-how'. Does the foreign collaborator dispose of or part with the 'know-how', or does he impart it as part of his business, i.e. impart it without substantially reducing the value to himself, although it may get 'diluted' by being communicated to others? In the latter case, the imparting of the 'know-how' is only a way of utilizing his stock-in-trade in the course of his business and the receipts therefrom will be a revenue receipt in his hands. On the other hand, if the foreign collaborator disposes of the same once and for all, then it could be said that the receipt in his hands is in the nature of a capital receipt. The difference was clearly pointed out by Justice Pennycuick when the learned Judge observed.[11]

> It was held, then, in the Rolls-Royce case,[12] that what is called 'know-how' in the hands of a manufacturer is an asset of such character that it may be communicated for value to another, on the one hand and in such manner that it loses its value to the trader – in which case the consideration is capital – or on the other hand in such manner that it retains its value to the trader – in which case the consideration must be brought into account in the computation of income profit. I hope that is not an undue simplication of the decision for the purpose of the present case. The Evans Medical Supplies case[13] was an instance of the former, the Rolls-Royce case, an instance of the latter type.

Related to this problem is the question whether the local concern, when it acquires the know-how, is required to return such know-how on the expiry of the agreement or not, i.e. does the agreement postulate return of the drawings and all the information that was received on the expiry of the agreement? In other words, is the importer only acquiring the know-how for a limited period for a limited purpose while the foreign collaborator retains the right to transfer the know-how to any third party after the expiry of the agreement or even during the course of the agreement? These aspects are important because if the importer is only given a limited right, it could be said that he has not acquired an enduring benefit and that any payment therefore by him is only in the nature of a revenue expenditure. The receipt in the hands of the foreign collaborator is only a revenue receipt, as he has not parted with an asset but has merely utilized the asset as stock-in-trade. But if, on the other hand, the local importer obtains an enduring advantage by not being required to return the know-how on the expiry of the agreement, then the expenditure in his hands may well be capital expenditure, and if the foreign collaborator disposes of the know-how once and for all, then it may be a capital receipt in his hands.

Having considered the difference between a capital receipt and a revenue receipt, the next question which one has to consider from a tax perspective is the status of the foreign collaborator in the host country where

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[10] 41 TC 556 (HL).
[11] Ibid., at p. 573.
[12] 40 TC 443; 56 ITR 580 (HL).
[13] 37 TC 540; 35 ITR 707 (HL).

the know-how or the plant and machinery is put to use by the local concern. The residential status of a foreign collaborator is very important as the tax consequences of his receipts would vary depending whether he is a resident or non-resident or ordinarily resident. It is common to find a national tax law which provides that if a person resides within the country for a specified number of days, he thereby becomes a resident. Who so ever is not a resident thereof, is a non-resident under the law. In the latter case only that income which accrues or arises within the country or is received within the country or deemed to accrue or arise within the country would be subjected to tax under the local law. We have already noticed that many countries have incorporated the concept of 'business connection', such that income arising out of an agreement is deemed to have accrued or been earned within the country, and is thus liable to tax therein.

The Supreme Court of India in CIT vs. R.D. Agarwal & Co.[14] held that the business connection contemplated under the Indian Income-tax Act involves a relationship between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or gains. According to the court, the concept of business connection predicates an element of continuity between the business of the non-resident and the activity in the taxable territories; a stray or isolated transaction not being normally regarded as a business connection. A business connection may take several forms, it may include both the carrying on of a portion of the main business of the non-resident and the activity in the taxable territories which facilitates or assists in the carrying on of that business. The expression "business connection" postulates a real and intimate relationship between the trading activity carried on outside the taxable territories and the trading activity within the territories, the relationship between the two contributing to the earning of income by the non-resident in his trading activity.

Where the national tax law deems a profit attributable to a business connection, it also generally provides that only that income or profit reasonably attributable to the activity in the host country is liable to tax. In other words, the national law generally provides for apportionment of such profits and seeks to tax only that portion of the profits which can reasonably be attributed to the business connection in the host country.

In summation, the first point that should be noted in dealing with the tax consequences of a foreign collaboration agreement is whether the foreign collaborator carried on any business within the taxable territories either through a branch office or an agent and if so, whether he automatically became a resident. If he remained within the country for a specified number of days as provided for under the national law then, again, he may be considered a resident. If, however, he had no branch office or agent in the taxable territory, the next question is whether he had any business connection in the taxable territories by which income could be deemed to accrue or arise. If, under the agreement, the foreign collaborator delivered the plant and machinery outside the taxable territories and received the payment outside the taxable territories, then clearly such income can not be taxed in the taxable territories. If, however, he participated in the setting up of the plant and machinery or rendered services, the foreign collaborator may be taxed on the income received or accrued in the taxable territories. Similarly, interest, royalty and fees for technical services are taxable if the moneys borrowed were used for the purpose of a business or profession carried on in taxable territories, or if property or information is so used. Services rendered for the purpose of the business or profession carried on in the taxable territories are, again, taxable under national law.

Closely connected with these problems is the question of the effect of devaluation of the currency in which payments are designated to be made under the foreign collaboration agreement. The general principle is that an increase in the payments as a result of a devaluation of the local currency is of the same nature as the original payments under the agreement. In other words, if the payment by the local concern is for the acquisition of a capital asset, then the increase caused due to devaluation of the local currency is again a payment on capital account. If, on the other hand, the payment under the agreement is a revenue expenditure in the hands of the local concern, the increased cost also will be in the nature of a revenue expenditure and deductible for tax purposes.

There are certain other aspects, like the existence of reciprocal arrangements between contracting States to afford protection for foreign investment in the host country, restrictive clauses placing restrictions on the modifications of design of the plant and machinery to suit the local conditions, clauses for tied-in purchases and sales as well as clauses relating to management control apart from restriction on exports, which should be taken into account when finalising a collaboration agreement.

For a comprehensive view on all these aspects, see the author's recent book "Foreign Collaboration Agreements – Some Issues", Taxation, 174, Jor Bagh, New Delhi, which also contains two model agreements – one a comprehensive agreement for imparting know-how and technical services and the other uniquely for imparting technical services – for use as an aid in finalising collaboration agreements.

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[14] (1965) 56 ITR 20.

Taxation in the People's Republic of China

Tax Laws – Tax Incentives – Tax Treaties

A Brief Introduction

By Eugen Jehle

Mr. Eugen Jehle was born in 1947 at Brenden, Waldshut district, Federal Republic of Germany. He started his professional career with a commercial apprenticeship at a bank, followed by studies in Business Administration. After obtaining his degree in 1975, he undertook supplementary studies in England and France. In 1977, he joined the International Bureau of Fiscal Documentation where he initially worked on tax issues concerning the Federal Republic of Germany. He later took over the function of General Editor of the Handbook on the United States/German Tax Convention – Debatin/Walter. He also studied and published on developments in the field of investment and taxation in Asia and the Pacific, particularly with respect to the People's Republic of China and some areas in the Pacific, including Tahiti, Tonga and Tuvalu. He has also taken a special interest in issues concerning the relationship between developing and industrialized countries in the field of taxation and the future development of tax systems as a whole.

I. INTRODUCTION

With the introduction of the policy of the "four modernisations" (i.e. modern agriculture, industry, national defence and science and technology) in the late 1970s, which included the opening of the economy to foreign enterprises, China had to redesign its tax system in order to cope with situations bound to arise in the wake of that economic reform.

To this effect, the Chinese authorities have enacted a considerable number of laws, regulations and rules in recent years which are thought appropriate to support the modernisation policy. This includes, in particular, legislation for the taxation of income of foreign enterprises, joint ventures and individuals which is of fundamental importance for foreigners, but it also includes new legislation for State-owned enterprises and collective enterprises in China.

What is thus currently found in China in the field of taxation is a mixture of "old legislation" as it had been enacted in the early years of post-revolution China, whereby the most important tax is the industrial and commercial consolidated tax, and "new legislation" enacted in recent years as indicated above.

Although the legislative framework in the field of taxation is gradually approaching completion, there are still a great number of open questions; due, quite normally and necessarily, to the absence of previous experience and case law.

This article briefly describes the tax system as it is currently in effect in China. However, it does not and cannot claim to be complete in every respect. It is also a follow-up and up-date of "The Tax System of the People's Republic of China – A Short Survey" published in *Bulletin for International Fiscal Documentation* 1982 at page 447, and a comparison with that article will quickly reveal that great progress has been made as regards the clarification of many unanswered questions. Moreover, another aspect of taxation has, meanwhile, attained great interest and relevance, namely, that of the tax treaties which China has concluded or is in the process of negotiating with other countries.

Contents

II. DIRECT TAXES AFFECTING INDIVIDUALS AND ENTERPRISES OTHER THAN STATE-OWNED ENTERPRISES

1. Foreign enterprise income tax

Introduction

As its name clearly indicates, this law, which was adopted on 13 December 1981 and entered into force on 1 January 1982, relates to the taxation of the income of those enterprises in which foreigners have an interest in some form or another and which (the income taxation) is not covered by the joint venture income tax or the individual income tax.

As a *general rule,* enterprises with a foreign interest in China and actively engaged in business there are subject to progressive tax rates, whereas enterprises which are not actively engaged in business in China ("passive income") are subject to a fixed rate of, generally, 20%.

There are, however, many exceptions to this general rule, and the most important one refers to enterprises which maintain their activities in *specific areas* such as Special Economic Zones (SEZs), Economic Development Zones (EDZs) or "Old City" Areas. (See Section V).

Taxable persons

(a) *Foreign enterprises present in China*

All entrepreneurial undertakings in China in which foreign enterprises are actively involved except equity joint ventures are subject to the foreign enterprise income tax.

In identifying the taxable person, the underlying legislation does not refer to any specific kind of legal structure but uses the general term "foreign enterprises operating in China".

This term includes "foreign companies, enterprises or other economic organizations" that

- carry on undertakings in cooperation with Chinese enterprises such as cooperative production, processing trade; or
- participate in contractual joint ventures; or
- maintain permanent representative offices that carry on certain activities as prescribed in the Interim Provisions of the Ministry of Finance of 14 May 1985; or
- have permanent establishments in China.

(b) *Foreign enterprises not present in China*

Foreign enterprises that are not actively involved in undertakings in China but which receive "passive income" are subject to tax on their Chinese-source income. There are, however, many exceptions to this rule.

Taxable income

As indicated above, a basic distinction must be made between:

(a) *Foreign enterprises present in China*

Subject to the foreign enterprise income tax is income, after consideration of "costs, expenses and losses", of a given year that is derived from:

- *production and business:* e.g. operations in industry, mining, communications, transportation, agriculture, forestry, animal husbandry, fisheries, poultry farming, commerce, services and other trades; the last category includes in particular the gross income of permanent representative offices of foreign enterprises;
- *other sources:* e.g. dividends, interest income from lease or transfer of property, patent rights, proprietary technology, ownership of trademarks, copyrights, etc., and other non-operating earnings.

Capital gains are included in taxable income as are "ordinary" income items.

The following general rules are important in determining the taxable income of enterprises that actively engage in business in China:

- taxable income is defined as net income after gross revenue has been reduced by costs, expenses and losses;
- income must be calculated on an annual basis, and as a general rule, the tax year is the calendar year (1 January – 31 December); however, other taxable periods may be applied for;
- the procedure for calculating taxable income is precisely set out in the underlying rules and regulations which distinguish among industry, commerce, service trades and other trades.

The foreign enterprise income tax law identifies several items of income that are exempt from the tax. (For details, see "Tax incentives" below".)

The foreign enterprise income tax law also identifies certain expenses that are either not deductible at all or are deductible only to a limited extent. Non-deductible expenses include payment of national or local income tax, penalties for illegal operations, overdue payments and tax penalties, certain losses covered by insurance, royalties paid to the head office, and other expenses that are not relevant to production or to the business operation.

Expenses which are deductible, under certain restrictions, are basically of three types: administrative, interest and entertainment expenses. Administrative expenses (also known as overhead expenses) are deductible only if certain requirements are satisfied. For example, any such payment must be for a service rendered directly to the undertaking in China. Interest payments are deductible only if the interest rate passes the test of "reasonableness". Entertainment expenses are deductible only if they do not exceed certain percentages, i.e. a certain percentage of either net volume of sales or the total annual business income. These provisions are clearly designed to combat tax evasion in its various forms.

It must be noted that, in practice, foreign enterprises may elect to be taxed on a deemed profit basis, rather than on the basis of actual profits as calculated. Under the deemed profit system, a fixed percentage of the gross revenue obtained by the foreign enterprise is regarded as taxable profit, and tax will be levied thereon.

The provisions concerning depreciation, treatment of losses, valuation of stock, etc., are set out in the underlying legislation and basically follow the schemes commonly employed in other countries.

Specific rules have been established for certain specialised activities such as, for instance, the exploration and exploitation of offshore oil.

There are also specific rules for *permanent representative offices of foreign enterprises*, for which the following types of revenue are defined as taxable income:

- commissions, rebates and fees received on behalf of the home office for engaging in business as agents for other enterprises outside the territory of China, or for liaison, negotiation and middleman services within Chinese territory;
- payments in scheduled installments or in accordance with the volume of commissioned services made to permanent representative offices by their clients (including their home offices) for conducting market surveys, business liaison, information or consultation within Chinese territory;
- commissions, rebates and fees received for engaging in business within Chinese territory as the agents of other enterprises or for liaison, negotiation or middleman services for economic and trade transactions between other enterprises.

The assessment base is usually the amount of income calculated according to the general standards, as derived from the underlying documentation (general rule). In other cases, i.e. where no such documentation is available, the tax is assessed on a deemed profit, provisionally determined to be 15% of business proceeds of the permanent representative office of the foreign enterprise.

(b) *Foreign enterprises not present in China*

Foreign enterprises that are not actively involved in undertakings in China but that receive income such as dividends, interest, rentals, royalties and other types of payments described as taxable income by the Ministry of Finance are, in principle, subject to a flat rate tax (general rule). There are certain exceptions to this rule. (See also "Tax incentives" below.)

Tax rates

(a) *Foreign enterprises present in China*

The foreign enterprise income tax is levied at progressive rates. The following amounts are taxed at these rates of (national) income tax:

Range of annual income (yuan)	*Tax rate (%)*
below 250,000	20
250,000 – 500,000	25
500,000 – 750,000	30
750,000 – 1,000,000	35
above 1,000,000	40

In addition to the national income tax, a local income tax of 10% is levied on the same amount of taxable income (flat rate).

(b) *Foreign enterprises not present in China*

As a general rule, these enterprises are subject to a 20% flat rate income tax on such income from China as:

- dividends
- interest
- rentals
- royalties
- other types of payments described as taxable income by the Ministry of Finance.

There are, however, exceptions to this rule.

This tax must be withheld by the paying unit.

For the relevant tax rates: (1) for undertakings in specific areas, see Section V of this Article; (2) for payments of dividends, interest, etc., to countries with which China has concluded a tax treaty, see Section VIII.

Tax incentives

(a) *Foreign enterprises present in China*

Foreign enterprises that maintain specific undertakings in China may benefit from the following tax incentives upon approval by the tax authority:

- An exemption from income tax in the first profit-making year and a reduction of 50% in the second and third profit-making years is granted to long term undertakings (i.e. at least 10 years of operation) that deal with farming, forestry, animal husbandry, deep well coal exploitation and other low profit operations. These undertakings may, upon approval of the Ministry of Finance, further benefit from a tax rebate of 15 to 30% for 10 years following the incentive periods mentioned above.
- An exemption from or a deduction in the local income tax of 10% may be applied for with the competent Government authority of the Province, Municipality or Autonomous Region if small-scale production or low profit operations are being maintained (i.e. the annual income of the foreign enterprise is less than 1,000,000 yuan).

(b) *Foreign enterprises not present in China*

The Foreign Enterprise Income Tax Law and the pertinent regulations offer a number of exemptions from or a reduction of the (20%) withholding tax on:

- certain interest payments;
- certain rental payments;
- certain royalty payments.

(For reductions under tax treaties see Section VIII.)

Interest payments are exempt from tax if they are made to an international finance organization (e.g. IMF, World Bank, etc.) for loans granted to the Chinese Government or Chinese official bodies. An exemption is also available where loans are provided by foreign banks at a "preferential interest rate" (i.e. at least 10% lower than at international capital markets). An exemption from tax is, for instance, available for those interest payments where the arranged interest rate does not exceed the international interbank call rate, or for seller's credits, or for interest payments that are made in the context of carrying through a joint undertaking in the form of a contractual joint venture, processing trade or a similar form of cooperation, or where those payments are made by the China National Offshore Oil Corporation.

A reduction in the tax rate (to 10%) for interest payments is also available for certain loans granted between 1983 and 1985.

As regards *rental payments,* it has been reported that leasing fees that occur in the course of carrying through some kind of compensation trade agreement may be exempt; and a reduction down to a tax rate of 10% may be granted for specific types of lease-sale contracts that are signed between 1983 and 1985.

As regards *royalty payments,* fees for the use of proprietary technology, fees for consultancy services, technology instruction, technical assistance or technical service may either be exempt or, respectively, may benefit from a reduction of the foreign enterprise income tax where those royalties are paid for the use of technology that is "advanced" or provided on "preferential terms", such as fees for blueprints and documentation.

Formal requirements

(a) *Foreign enterprises present in China*

– *Filing of returns*

Foreign enterprises are required to file with the local tax authorities:
- provisional income tax returns within 15 days after the end of each quarter;
- final income tax returns within 4 months after the end of the fiscal year, together with:
  - final accounting statements;
  - an audit certificate by a chartered public accountant registered in the People's Republic of China (unless otherwise stipulated).

  The return must be filed irrespective of whether the enterprise's operations resulted in a profit or a loss.

Where special circumstances prevent foreign enterprises from filing a tax return within the prescribed time period, they may submit an application for extension of the time limit to the local tax authority within the periods described above.

Tax return forms are provided by the competent local tax authority.

– *Payment of tax*

Foreign enterprises present in China are required
- to make quarterly installments (provisional income tax) within 15 days after the end of each quarter.

These quarterly installments are calculated on the basis of
- the actual quarterly profits; or
- 1/4 of the planned profit of the current year; or
- 1/4 of the actual profit of the preceding year;
- to make the final payment within 5 months after the end of the fiscal year. Where there is a deficiency between the total amount of quarterly installments and the final assessed amount of tax due, this must be paid within this time period.

– *Appeals*

Where there is a disagreement between a foreign enterprise and the tax authority as to the amount of tax due, the enterprise may apply for reconsideration with a higher tax authority. When a foreign enterprise applies for reconsideration, it is nevertheless obliged to pay the alleged tax due within the prescribed time period. The competent tax authority is required to come to a decision within 3 months after receiving the application. If this decision does not satisfy the foreign enterprise, it may bring the matter to the local People's Court.

(b) *Foreign enterprises not present in China*

Where foreign enterprises not present in China derive income from China such as dividends, interest, rentals, royalties and other types of payments described as taxable income by the Ministry of Finance, it is the paying unit that is compelled to act as withholding agent for the taxpayer (i.e. the foreign enterprise not present in China) for each payment made.

For each payment made and tax withheld, the withholding agent must submit an income tax return and transfer the money withheld to the State Treasury within 5 days.

2. Joint venture income tax

Introduction

On 8 July 1979, the *Law on Joint Ventures using Chinese and Foreign Investment* was promulgated which, for the first time in post-revolution China, permitted the influx of foreign equity capital into new enterprises in China. The Law, as cited, prescribes the establishment of a joint venture as a limited liability company; however, to date (17 June 1985) no specific legislation governing that legal form of carrying on an enterprise has been released. Presumably because of this situation, there has been a development in the establishment of joint ventures in China which distinguishes between two types of joint ventures; (a) equity joint ventures, and (b) contractual joint ventures. Participation in the capital of an undertaking in the form of a joint venture in China is only given in case of an equity joint venture; a contractual joint venture is usually simply a kind of cooperation which is based on a contract and provides for the allocation of the profits of a specific project rather than in capital participation.

The distinction between the equity vis-à-vis the contractual joint venture is very important as regards the tax consequences; only the equity joint venture is subject to the joint venture income tax whereas in the case of a contractual joint venture, the foreign partner is subject to the foreign enterprise income tax on his share of income from the undertaking.

It should also be noted that, where an equity or contractual joint ventue is carrying on its activities in a *specific* *area,* the specific tax treatment as prescribed for those areas generally prevails.

Taxable persons

Subject to the joint venture income tax is any equity joint venture with Chinese and foreign capital. Where such a joint venture has branches in China and abroad, it is always the head office in China that is the taxable person and thus is liable for payment of the Chinese taxes, regardless of whether the income was derived within or outside China. Where a joint venture or its branch derives income from abroad and has paid foreign income taxes thereon, the foreign taxes may be credited against the income tax liability in China. In this regard, it may be noted that, to date (17 June 1985) China has concluded 6 comprehensive treaties for the avoidance of double taxation, namely with Belgium, France, the Federal Republic of Germany, Japan, the United Kingdom and the U.S.A. (see also section VIII "Tax Treaties").

Taxable income

Taxable income comprises the world-wide income of an equity joint venture, i.e.

- *income from production and business,* such as from operations in industry, mining, communications, transportation, agriculture, forestry, animal husbandry, fisheries, poultry farming, commerce, tourism, food and drink, service and other trades;
- *income from other sources* such as dividends, bonuses, interest and income from lease or transfer of property, patent rights, ownership of trade marks, proprietary technology, copyrights and other sources.

Taxable income is calculated as:

(gross income of the relevant year) – (costs, expenses and losses) = net income
(= taxable income)

Where an equity joint venture receives foreign currency, the relevant amount will be converted into renminbi[1] at the exchange rate quoted by the State General Administration of Foreign Exchange Control on the day the tax payment certificates are made out.

Moreover, the following rules must be adhered to:

(1) the taxable period is the calendar year, 1 January to 31 December;

(2) losses may be carried forward and set against the profits of the following year; the maximum period for carrying forward losses is five years;

(3) in calculating taxable income, a distinction is made among these four types of activities:

(a) *Industry:*
- Cost of production of the year = actual material used in production of the year + actual wages + manufacturing expenses.
- Cost of production of the year = inventory of semi-finished products at the beginning of the year and in-production products + cost of production of the year – inventory of semi-finished products at the end of the year and in-production products.
- Cost of sale of product = cost of product of the year + inventory of product at the beginning of the year – inventory of product at the end of the year.
- Net sales of product = gross sales of product – (sales returns + sales allowances).
- Profit from sale of product = net sales of product – tax on sales – cost of sales – (selling expenses + administrative expenses).
- Amount of taxable income = profit from sale of product + profit from other operations + non-operating income – non-operating expenditure.

(b) *Commerce:*
- Net sales = gross sales – (sales returns + sales allowances).
- Cost of sales = inventory of merchandise at the beginning of the year + (purchase of the year – (purchase returned + purchase discount) + purchase expenses) – inventory of merchandise at the end of the year.
- Sale profit = net sales – sales tax – cost of sales – (selling expenses + overhead expenses).
- Amount of taxable income = sales profit + profit from other operations + non-operating income – non-operating expenditure.

(c) *Service trades:*
- Net business income = gross business income – (business tax + operating expenses + overhead expenses).
- Amount of taxable income = net business income + non-operating income – non-operating expenditure.

(d) *Other lines of operation:*
For other lines of operation, reference is made to the above mentioned formulae for calculation.

(4) depreciation normally takes place in using the straight-line method. The basis for depreciating fixed assets is determined as follows:

original price – residual value = depreciation basis

In principle the residual value is 10% of the original price; if a lower value is desired, approval must be sought from the local tax authorities.

Where a fixed asset remains in use after having been fully depreciated, there is no further depreciation allowance.

The useful life for computing depreciation of fixed assets is as follows:

- the minimum useful life for houses and buildings is 20 years;
- the minimum useful life for trains, ships, machines and equipment and other facilities for the purpose of production is 10 years;

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[1] The overall name of the currency of the People's Republic of China is renminbi. Its unit is the yuan. One yuan equals ten jiao. It is not a convertible currency.

- the minimum useful life for electronic equipment and means of transport other than trains and ships is 5 years.

Where specific reasons justify either a faster depreciation or a different method, the joint venture must submit an application to the local tax authorities for examination which will be transferred to the Ministry of Finance for approval.

(5) Intangible assets such as patent rights, trademarks, copyrights, know-how, rights of use of sites and other rights are assessed as follows:

- where intangible assets are transferred as a contribution in kind, the assessment is on the price that was agreed upon by the parties at the time of investment;
- where intangible assets are purchased, the assessment is on the actual payment price.

The amortization of intangible assets takes place as follows:

- where there is a time limit for use, amortization shall take place within that time limit;
- where there is no time limit for use, amortization shall take place within 10 years.

Tax rate

Income tax for equity joint ventures is levied at a flat rate of 30% which is the national tax rate. In addition, a local surcharge of 10% of the national tax is levied and the total tax burden is thus 33%. However, the People's Government of the Province, Municipality or Autonomous Region in which the joint venture is located may grant an exemption or rebate of this local surcharge.

Where the foreign participant remits his share in the profits outside China, a remittance tax of 10% falls due.

Tax incentives

There are basically two types of tax incentives available for equity joint ventures in China:

- Where a foreign participant in an equity joint venture reinvests a portion of his profits in China for a period of at least 5 years, he is entitled to a refund of 40% of the equity joint venture income tax paid on that portion;
- Where an equity joint venture is of a long term nature, or maintains activities in a low profit field or in a "handicapped"[2] area, a tax holiday may be applied for the first profit-making year(s), and a tax rebate of up to 50% for subsequent years may be granted by the tax authorities.

Again it should be noted that, where an equity joint venture is carrying on its activities in a *specific area,* the specific tax treatment as prescribed for that area applies.

Formal requirements

(a) *Filing of returns*

Provisional joint venture income tax returns must be filed with the local tax authority within 15 days after the end of each quarter.

A final tax tax return must be filed together with final accounting statements within 3 months of the end of the tax year with the local tax authorities irrespective of profit or loss. An audit report by a chartered public accountant registered in the People's Republic of China must also be submitted.

(b) *Payment of tax*

The computation of tax must be made in Chinese currency. Where there is income in foreign currency, it is converted in accordance with the exchange rate fixed by the competent authority.

The joint venture income tax must be paid in quarterly provisional installments due within 15 days after the end of each quarter. The amount of tax is computed as ¼ of the planned annual profit or the actual income in the preceding year.

The final payment shall be made within 3 months following the end of a tax year. Excess payments will be refunded by the tax authorities whereas deficiencies must be paid by the joint venture.

Where a joint venture fails to pay the tax due within the prescribed time period, the competent tax authority may:

- set a new time limit for the payment of tax due; and
- levy an overdue surcharge of 0.5% per day of the tax due, starting from the first day of default.

(c) *Appeals*

Where there is a dispute about the tax payment between the local tax authorities and the joint venture, the disputed tax due must nevertheless be paid by the joint venture. However, the joint venture may then apply for reconsideration before a higher tax authority who is required to take a decision within 3 months after receiving the application.

If the decision of the higher tax authority is not accepted by the joint venture, it may then apply for proceedings before the local People's Court.

3. Individual income tax

Introduction

Since 10 September 1980, post-revolution China has had an individual income tax. Prior to the entry into force of the underlying legislation, individuals were, in principle, not subject to income tax in China unless they maintained an entrepreneurial activity that fell within the Industrial and Commercial Income Tax Regulations.

Taxable persons

The relatively high basic exempt amount of 800 yuan per month in practice eliminates most Chinese citizens from the individual income tax. As to the different

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[2] "Handicapped" areas are those located in remote regions and/or which suffer from poor soil conditions or other natural handicaps.

types of *taxable persons,* the following distinctions may be made:

(a) *Residents*

Within the definition of "resident", a further subdivision may be made according to these features:

- Persons subject to unlimited taxation: individuals residing in China for more than 5 years are subject to Chinese income tax on their world-wide income from the 6th year of residence.
- Persons subject to restricted unlimited taxation: individuals residing in China for 1 year or more but less than 5 years are subject to tax on their Chinese-source income *and* that part of foreign-source income that is remitted to China (temporary absence does not count in the determination of the number of years).

  Reportedly, it is possible for *foreign expatriates* to apply for an exemption from the Chinese income tax for that part of their income which they derived outside China; it is not significant whether or not such income was remitted into China.
- Persons subject to limited taxation: individuals residing in China for less than 1 year are subject to Chinese income tax on their Chinese-source income only. Where an individual stays in China for less than 90 days, his employment income and compensation for personal services is exempt from Chinese taxation provided that it is paid by employers located outside China.

(b) *Non-residents*

Persons subject to limited taxation: individuals not resident in China are subject to Chinese income tax on their Chinese-source income.

The distinction between *resident* and *non-resident* is significant with respect to certain categories of income, namely:

- compensation for personal services;
- royalties;
- income from lease of property;

since the right to claim the allowance depends on this distinction of status.

Taxable income

There are 6 types of taxable income classified into 3 different categories:

(a) *Income taxed at progressive rates:*
   (1) employment income;

(b) *Income taxed at a flat rate (with deductions for residents):*
   (2) compensation for personal services;
   (3) royalties;
   (4) income from lease of property;

(c) *Income taxed at flat rate (without deductions):*
   (5) taxable interest, dividends and bonuses;
   (6) other kinds of income (specified as taxable by the Ministry of Finance).

Where income is paid in kind or in marketable securities rather than in money, that portion of the income thus paid shall be computed in terms of money according to the market price at the time of receipt. Employment income (a)(1) comprises wages, salaries, certain bonuses and year-end extras paid in the course of a current employment relationship.

Exemption from Chinese tax liability

- employment income paid by employers outside China to individuals whose period of residence in China does not exceed 90 days;
- severance or retirement pay for executives, staff members and labourers;
- salaries of foreign diplomatic personnel (diplomats in foreign embassies; consuls; other persons enjoying the the same treatment as diplomats).

Extension of Chinese tax liability

Individuals (with Chinese citizenship) who are sent abroad by Chinese governmental offices to work are nevertheless subject to tax in China on their employment income.

Tax rates

Employment income is taxed at these progressive rates:

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

Items of income that belong to category (b) above are, in principle, taxed at a flat rate of 20%. Residents are entitled to a lump sum deduction for expenses of 800 yuan per such payment (compensation for personal services, royalties or income from lease of property), if the payment is less than 4,000 yuan or of 20% of the payment if it exceeds 4,000 yuan. Thus, if the single payment is 2,000 yuan, the effective tax burden is 12%. For payments in excess of 4,000 yuan, the effective tax burden is 16%. Non-residents are not entitled to this deduction, and the 20% rate applies to income which falls in this category.

Example:	*yuan*
Royalty	6,000
Allowance (=20% of 6,000 yuan)	1,200
Chargeable income	4,800
Tax:	960

Items of income within category (a) above are, in principle, taxed at a flat rate of 20% and no deductions are allowed. However, some exemptions are available. For example, interest that is defined as interest from a savings deposit in a State or cooperative bank in China or any other bank authorised by the State bank is exempt from the individual income tax. Dividends derived from a joint venture or an urban or rural cooperative organization are also exempt for residents.

Formal requirements

(a) *Filing of returns*

In principle, taxation of income, according to the Individual Income Tax Law, is done through withholding the tax; this is done by withholding agents. Withholding agents are required to deliver "itemized records for future reference" of the underlying taxes upon the transfer of taxes due.

In such a case, as well as in cases where taxpayers themselves are obliged to file personal returns on income from Chinese sources, this must take place within the first 7 days of the following month by the withholding agent or the taxpayer, as the case may be. The obligation to file a personal return applies to those taxpayers who are not covered by the withholding procedure.

Taxpayers who earn income outside China are required to file a tax return within 30 days of the end of each year. Foreign-source income is computed and taxed separately from Chinese-source income.

(b) *Payment of tax*

Individual income tax is paid either through withholding by a withholding agent or through direct payment by the taxpayer. The amount of tax due is transferred to the State treasury.

For China-source income the transfer must take place within the first 7 days of the following month.

Taxpayers earning income outside China are required to pay the tax due within 30 days of the end of the year.

Payments (e.g. in cash, remittance or transfer of accounts) must be made in Chinese currency.

Where the withholding agent or taxpayer fails to pay the tax in due course, the tax authority will levy a surcharge of 0.5% per day on tax overdue and fix a new time limit.

In case of disputes and subsequent appeals, the payment of the tax due must nevertheless take place within the time limits prescribed above.

Individuals who intend to leave the country must pay their taxes to the local tax authority 7 days before departure.

(c) *Appeals*

Withholding agents or taxpayers disagreeing with the tax authorities on specific issues such as the amount of taxes may apply for reconsideration of their case to a higher tax authority. The tax authority concerned is required to come to a decision within 3 months from receipt of the application.

If the decision of the higher tax authority is not accepted by the withholding agents or the taxpayer, they may apply for proceedings before the local People's Court.

4. Industrial and commercial income tax[3]

Until the introduction of the policy of the "four modernizations", this tax was, together with the agricultural tax, the only tax on income levied in post-revolution China. It was based on legislation promulgated in 1950.

Subject to this tax were "industrial and commercial enterprises" (collective enterprises such as cooperative societies, industrial and commercial activities of people's communes), mixed enterprises (i.e. partly public, partly privately owned) and private enterprises. State-owned enterprises and agricultural activities carried on by people's communes were not subject to this tax.

The industrial and commercial income tax has recently been abolished and has been replaced by four different types of taxes: the product tax (for industries), the sales tax (for commercial enterprises), the salt tax and the value added tax. These four types of taxes are applicable to both collective enterprises and State-owned enterprises. They do not apply, however, to foreign enterprises or joint ventures. Due to the recent repeal and the obvious irrelevance to foreign enterprises, this tax is mentioned in this article only very briefly, because of its similarity to the industrial and commercial consolidated tax and for historical reference.

Taxable income for purposes of this tax was net revenue calculated according to the accrual method. No distinction was made among various items of income. For example, capital gains, i.e. extraordinary profits from the disposal of fixed assets, were automatically included in the profits.

The following items were deductible in calculating taxable income: production costs, administrative expenses and other expenses, depreciation using the straight line method and the industrial and commercial consolidated tax already paid.

Many exemptions were provided but the situation varied from province to province. An exemption was, in certain cases, available for specific branches of industry and commerce or an exemption was granted for retained profits and for new industrial enterprises suffering financial problems.

The industrial and commercial income tax was levied, at the national level, at progressive rates ranging from 5.75% for income up to 300 yuan to 34.5% for income of 10,000 yuan or more. In addition, a local surcharge was levied in some cases, which ranged from 10% to 100% of the national tax.

5. Agricultural tax

The agricultural tax is levied on agricultural activities which traditionally have been undertaken by people's communes and the taxable person is the production team of the commune. The tax is levied on the "yield of the average harvest" which is a projected amount that is usually fixed for a certain number of years (normally 3 -

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[3] Not to be confused with the industrial and commercial consolidated tax, discussed under "indirect taxes".

5 years) on the basis of the harvests of previous years. Any yield in excess of the "yield of the average harvest" is exempt from taxable income.

A basic exemption is allowed. In addition, exemptions from, and reductions of, the agricultural tax may be granted when a natural disaster occurs, when new cultivations are being started, or when the agricultural activities take place in so-called "handicapped" areas.

The agricultural tax is levied at a proportional rate but the actual rate depends on the region and usually varies from 13% to 19%. In addition, a local surcharge of up to 22% of the tax may be levied. Usually this tax is paid in kind but recent reports indicate that a gradual change to cash payment is envisaged.

It is not clear at present whether the recent reforms in the field of agriculture will also affect the taxation of these activities.

III. INDIRECT TAXES

1. Industrial and commercial consolidated tax

Introduction

This tax is currently one of the most important taxes in China, and it applies to all activities in China in which foreigners have an interest[4].

This tax can be classified as a sales (turnover) tax although it also has features of an excise duty. It is generally levied at each stage of processing, delivery etc. No credit is given for tax previously paid and it therefore has a cascade effect. The rates vary from 1.5 to 69%; certain exemptions are provided in the rules.

The industrial and commercial consolidated tax is levied by the Central Government.

In addition, a surcharge of a flat 1% may be levied by the local authorities, based on the amount of tax. Thus, where the rate applicable according to the general rate table is 20%, the total tax charge is 20.2%.

Taxable persons

The industrial and commercial consolidated tax generally applies to all those activities in which foreigners have an interest, including permanent representative offices of foreign enterprises. (For the taxation of State-owned enterprises, see Section VII.) The legal status of the taxable persons is not relevant in this context.

A basic distinction is made between enterprises which are engaged in:

(a) industrial and agricultural production;
(b) retail trade;
(c) transportation and telecommunications;
(d) service trade.

Taxable transactions

(a) *Domestic transactions*

A taxable event arises whenever the taxable item is transferred from one enterprise or person to another. Where any item passes through several stages of manufacture within the same enterprise, no tax is generally due.

(b) *International transactions*

- General rule
  When any item is imported into China, the act of delivery usually represents a taxable event.

  When any item is exported from China, the act of delivery is the taxable event.
- Exemptions
  A great number of exemptions from, or reductions in, the industrial and commercial consolidated tax have recently been introduced. They include, for instance, regulations for the importation of advanced machinery and equipment or materials as required for the construction of factories, etc., insofar those items represent the foreign partner's contributions to a joint venture. Similar rules are established for undertakings which represent Chinese-foreign cooperative exploitations of offshore petroleum.

  The most important exemptions/reductions concern, however, undertakings in specific areas such as Special Economic Zones (SEZs), Economic Development Zones (EDZs), and Old City areas.

  Before such a tax advantage is granted, the following formal requirements must normally be complied with:
  - registration of the enterprise with the competent Customs Office;
  - presentation of the underlying contract and licenses, at the places of importation/exportation, where required;
  - application must be filed prior to the importation/exportation.

As far as ordinary *international trade dealings* are concerned, it is common practice to include a clause in the underlying contracts which provide for this tax to be borne by the (Chinese) buyer or seller, as the case may be.

Taxable base

The taxable base generally corresponds with the category of activity in which an enterprise is engaged.

Type of enterprise	*Taxable base*
Industrial and agricultural production	gross receipts
Retail trade	gross receipts
Transportation and telecomunications	gross income
Service trade	gross income

Tax rates

As a general rule, the tax rates reflect the degree of necessity of a particular item to the economy as such

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[4] For some time, the *industrial and commercial income tax* was levied on *domestic* Chinese enterprises. That tax was similar to the industrial and commercial consolidated tax. As stated above, that tax has recently been repealed and replaced by taxes that apply to State-owned enterprises and collective enterprises.

and/or to the average consumer. Thus, basic items are taxed at a low rate (lowest rate: 1.5%) whereas luxury goods are taxed at rather high rates (highest rate: 69%). In addition, a local surcharge of 1% may be levied on the amount of tax.

Type of activity	*Taxable base*	*Tax rate span (%)*
Industrial and agricultural commodities	gross receipts	1.5 to 69
Retail sales	gross receipts	3
Transportation and telecommunication services	gross income	2.5
Service commissions	gross income	3-7[5]

Formal requirements

(a) *The filing of returns*

The amount of industrial and commercial consolidated tax due is self-assessed by the taxable enterprises, and its calculations and reporting must take place on Government supplied forms. This form must be filed with the local branch of the People's Bank of China. Where items are imported into China, the Customs Administration collects the industrial and commercial consolidated tax (in addition to the customs duties).

(b) *The payment of tax*

The period within which this tax must be paid depends on the size of the enterprise and may be 1, 3, 5 or 10 days or 1 month after sales.

Where the current tax liability cannot be calculated within the time periods prescribed, the enterprise must make a pre-payment based on the tax liability of the previous period and a final settlement will be made in the next period.

Where a taxpayer does not comply with the time limits for the payment of tax as fixed, the tax authority may levy a fine of a certain percentage of the amount of tax per day.

(c) *Appeals*

Where a taxpayer disagrees with the tax authority about the amount of tax to be paid, etc., he may, after the payment of the tax, appeal within 20 days to the next level of the tax authority or the local people's committee. If he does not agree with the findings of this body either, he may appeal to the next higher authority.

2. Customs duties

Although, as a general rule, customs duties are not regarded as taxes, they are nevertheless mentioned here because of their great importance both as a source of revenue for the Chinese Government and as a possible cost factor for foreign enterprises which carry on undertakings in one form or another in China.

Import duties[6]

The tariff on imports is classified into 17 categories which are subdivided into 939 tariff items, and a distinction is made between the "minimum tariff rate" and the "general tariff rate". The former is the rate that is generally applied to imports from countries with which China has concluded a trade agreement, and the general tariff rate applies to imports from all other countries. The applicable rates may be as high as 400% for luxury items. However, a considerable number of possibilities to either obtain an exemption from, or a reduction in, the applicable rates is available, particularly for those enterprises which operate in Special Economic Zones (SEZs), Economic Development Zones (EDZs) and Old City areas.

Export duties

Since 1 June 1982, China has levied export duties on a rather small number of items such as paddy rice, sugar, fish, nuts, pearls and certain raw materials.

IV. MISCELLANEOUS TAXES, EXCISE DUTIES, REGISTRATION TAXES AND LICENSE FEES

1. Urban real estate tax

The urban real estate tax, or municipal property tax, is levied either on the value of the real property in question or on the rentals of houses.

The applicable assessment base for the urban real estate tax depends upon a number of factors, including the location, condition of the house etc. The amount of tax due is usually determined on one of these formulae:

- 1.2% per annum of the assessed value of the house; or
- 1.8% per annum of the rentals of the house.

Where land is subject to tax, the value of usage is assessed according to specific principles and the rate which is generally applied amounts to about 1.8% of the assessed value per annum.

2. City maintenance and construction tax

This tax is levied on the basis of the rather detailed "Provisional Regulations of the City Maintenance and Construction Tax of the People's Republic of China", as issued by the State Council on 8 February 1985.

Taxable persons are defined as "all units and individuals who are paying production tax, value added tax and business tax". Thus, it must be assumed that State-owned enterprises are subject to this tax as indicated in initial reports, but as this is a local tax imposed by the local government it is not clear how far enterprises with a foreign interest will be subjected thereto.

The taxable base is the amount of the actually assessed production tax, value added tax and business tax.

The *tax rate* to be applied depends upon the size of the

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[5] Permanent representative offices of foreign enterprises are subject to tax on their gross income for services rendered according to the general rate table, but up to a maximum rate of 5%.

[6] As this article goes to press, reports have been received which indicate that China has changed its import duty classification.

municipality in which the taxpayer is located:

Locality	*Rate*
City districts	7%
County seats and other towns	5%
Other places	1%

The municipalities are expected to employ the revenue from this tax for the construction and maintenance of public facilities.

3. Salt tax

The salt tax is the oldest tax in China; it was first introduced some thousand years ago. It is administered by the "Salt Control Bureau"; the rate imposed (generally between 100 yuan 260 yuan per ton) depends on what the salt is used for. Salt used in agriculture and industry is exempt from salt tax as is salt for export.

4. Other taxes

Taxes which, in fact, are in the nature of license duties include the slaughter tax, the motor vehicles tax, the oil-burning tax, the architectural tax, and the cash-award tax. These are all local taxes and the tax amount appears to vary significantly. In terms of revenue, they are of minor importance and are mentioned here only for the sake of completeness.

V. TAX TREATMENT OF UNDERTAKINGS IN SPECIFIC AREAS

1. Introduction

With the introduction of China's new economic policy in 1978, better known as the "Four Modernizations", it became apparent that this policy required the importation of modern technology on a large scale. Initially, the implementation of the new policy took place through the acquisition of turnkey operations, mainly in heavy industry, but quite soon it became clear that this could not be maintained for an extended period since imports of investment goods took too great a share of China's import bill and were, thus, a drain on its foreign exchange reserve position. This situation is reflected through the following figures:[7]

	1979	*1981*
Portion of investment goods in total imports	1.2%	28.8%

In order to overcome this dilemma, China had to find a formula which would recognize the need for modern technology imports and thus start to integrate China into the world economy without suffering too great a drain in its foreign exchange reserve situation and without experiencing disturbances in the social sector through an immediate exposure of the entire country to foreign influences.

It is with this background that the Chinese Government decided to open the country to foreign investment on a gradual scale. In 1979, four *Special Economic Zones* (SEZs) were established, three of them in Guangdong Province (Shenzhen, Zhuhai, Shantou) and one in Fujian Province (Xiamen).

Based on the success the SEZs experienced in the early 1980s, the Chinese Government decided in 1984 to go a step further in opening up the Chinese economy through the establishment of *Economic Development Zones* (EDZs) (also referred to as *Economic and Technological Development Areas* or the *14 Open Cities:* Beihai, Dalian, Fuzhou, Guangzhou, Lianyungang, Nantong, Ningbo, Qingdao, Qinhuangao, Shanghai, Tianjin, Wenzhou, Yantai, Zhanjiang.[8]

Since operations in the SEZs and EDZs cannot be completely separated from operations in China's old cities in, for instance, infrastructure, the Chinese Government decided to give certain advantages to those projects in the old cities which supplement and support the activities in the SEZs and EDZs, mainly activities in: machine building, electronics, metallurgy, chemicals, building materials, light industry, textiles, packaging, medical equipment, pharmaceuticals, construction, agriculture, forestry, animal husbandry, aquaculture and related processing industries.[9] In this article, such locations are referred to as *"Old City Areas"*.

China has recently opened three more zones with a specific status, namely Changjiang Delta, Zhujiang Delta and Xiamen Delta. No details are yet known as to specific provisions that will govern foreign investment there but it is not unlikely that the tax provisions will be similar to those which apply in the Economic Development Zones (EDZs).

2. Operations in Special Economic Zones (SEZs)

As stated above, there are to date (17 June 1985) four SEZs in China. Although the legislative basis for operations in SEZs consists of many different rules and regulations, partly applicable in all SEZs, partly applicable in the SEZs of one Province, partly applicable in a specific SEZ only, the following survey of the tax treatment of operations in SEZs nevertheless reflects the general principles.

As regards *entrepreneurial undertakings* in the form of processing trades, cooperative production, joint development, contractual joint ventures, permanent representative offices of foreign enterprises, equity joint ventures or wholly foreign-owned enterprises, profits are treated equally in terms of taxation, i.e. subject to a flat 15% tax on taxable income (national tax). On top of this, the municipality *may* levy a local tax which is usually about 10% of the national tax (tax burden thus 16.5%). The people's government of the municipality

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[7] Oborne, Michael West: China's Early Windows on the World: The Special Economic Zones; in: OECD-Observer, No. 133, March 1985, at 11 et seq.

[8] It may be noted that Hainan Island appears to have a status similar to that of an EDZ. However, since the development of Hainan Island is still in its initial stage, it is not dealt with in this article.

[9] Gu Mu on Policies for Coastal Cities; Beijing Review No. 50 (10 December 1984), at 16 et seq.

in which the SEZ is situated may grant an exemption from, or a reduction in, this surcharge. An entrepreneurial undertaking may benefit from various tax incentives which lower that already modest tax rate even further. For instance, undertakings engaged in industry, communications and transport, in agriculture, forestry and livestock breeding, as well as undertakings which are based on a contract with a duration of 10 years or more may benefit, upon application and approval from the SEZ tax authorities, from a tax holiday for the first two profit-making years and a tax rebate of 50% for the three following years. Undertakings which are engaged in service trades and wherein the foreign investment exceeds US$ 5 million may benefit from a tax holiday for the first profit-making year and a tax rebate of 50% for the second and third years.

Dividends, interest, rentals, royalties and other sources of income received by foreign enterprises with no establishment in China are not taxed at the 15% rate as are profits derived through the entrepreneurial activities in the SEZ; rather, they are taxed at the rate of 10%; the decisive power of granting a further reduction or even an exemption lies with the people's government where the SEZ is located.

However, the low profit is not the only advantage that can be enjoyed by enterprise operations in SEZs. They can also benefit from an exemption from, or reduction in, the industrial and commercial consolidated tax (turnover tax) and customs (import) duties. Exempt are items imported into the SEZ such as machines, equipment, raw materials, spare parts and accessories, and other means of production needed for their own production. A rebate of 50% is granted for the importation of mineral oils, cigarettes, wines, and certain daily necessities brought in by business people. Exports from a SEZ may also benefit from a preferential treatment for purposes of the industrial and commercial consolidated tax. Where products produced in the SEZ are exported aroad, they are exempt, whereas products which are sold within the boundaries of the SEZ benefit from a rebate of 50%. The exemptions mentioned above usually do not apply, as regards both imports and exports, to those items that are included in the *State restriction list.*

Individuals residing in the SEZs may also benefit from tax rates which are more favorable than those in other parts of China; this is, however, subject to negotiation with the competent tax authorities.

Finally it should be noted that the urban real property tax and the transport means tax may also apply to enterprises or individuals in SEZs.

3. Operations in Economic Development Zones (EDZs)

As stated above, there are to date (17 June 1985) 14 EDZs in China. The legislative basis for operations in EDZs is not yet complete. The following survey of the tax treatment of operations in EDZs reflects the general principles as they have been established so far; it must, however, be noted that there are deviations from EDZ to EDZ.

As regards *entrepreneurial undertakings* in EDZs, they will mostly be in production enterprises and involve the introduction of new technologies and new products, as well as new industries. The form of cooperation will usually be that of processing trades, cooperative production, joint development, contractual joint ventures, equity joint ventures or wholly foreign-owned enterprises. Profits are generally treated equally in terms of taxation, namely they are subject to a flat 15% tax on taxable income (national tax). On top of this, the municipality *may* levy a local tax which is usually about 10% of the national tax (tax burden thus 16.5%). The people's government of the municipality in which the EDZ is situated may grant an exemption from or a reduction in this surcharge. However, like SEZs, an EDZ entrepreneurial undertaking may benefit from various tax incentives which lower that already modest tax rate even further. For instance, undertakings which are based on a contract with a duration of 10 years or more may benefit, upon application and approval from the EDZ tax authorities, from a tax holiday for the first two profit-making years and a tax rebate of 50% for the three following years.

Dividends, interest, rentals, royalties and other sources of income received by foreign enterprises with no permanent establishment in China are not taxed at the 15% rate as are profits derived through the entrepreneurial activities in the EDZ; rather, they are taxed at the rate of 10%, whereby the decisive power of granting a further reduction or even an exemption lies with the people's government where the EDZ is located.

Again, like SEZs, the low profit tax is not the only advantage that can be enjoyed by enterprises operating in EDZs. They too can also benefit from an exemption from or reduction in industrial and commercial consolidated tax (turnover tax) and customs (import) duties exempting capital goods imported into an EDZ such as machines, equipment, raw materials, spare parts and accessories, and other means of production needed for their own production. Exports from an EDZ may also benefit from a preferential treatment for purposes of the industrial and commercial consolidated tax; products produced in the EDZ and exported abroad are exempt (products which are sold within China are subject to tax at normal rates).

Individuals who reside in EDZs usually do not receive preferential treatment but specific arrangements may be negotiated.

Finally it should be noted that the urban real property tax and the transport means tax may also apply to enterprises and individuals in EDZs.

4. Operations in Old City Areas

It appears there are presently 17 Old Cities (namely: Beihai, Dalian, Fuzhou, Guangzhou, Lianyungang, Nantong, Ningbo, Qingdao, Qinhuangdo, Shanghai, Shanton, Tianjin, Wenzhou, Xiamen, Yantai, Zhanjiang, Zhuhai) which qualify as "Old City Areas" in the sense that, being "the city" to which one of the SEZs or EDZs is related, they may qualify for specific tax treatment under certain circumstances.

As far as *entrepreneurial undertakings* in these Areas are concerned in which foreigners have an interest, the general rule is that they are subject to the joint venture income tax (in case of equity joint ventures) or to the foreign enterprise income tax (in all other relevant cases) at the ordinary rates.

However, the following incentives may be obtained upon application to, and approval from, the Ministry of Finance:

- The profits of enterprises whose operation or investment takes place using modern technology or know-how, *and* where the overseas share in the investment exceeds US$ 30 million, *and* where the investment is of a long-term nature or takes place in the fields of energy, communication or port construction, may be subject to tax at the *flat rate of 15% on taxable income.*
- The profits of enterprises that are already in existence and whose activities cover one of these fields:
  - machine building, electronics industry;
  - metallurgy, chemicals, building materials;
  - light industry, textiles and packaging;
  - medical apparatus, pharmaceuticals;
  - agriculture, forestry, animal husbandry, aquaculture, and related processing industries;
  - building construction

  may be subjected to income tax on only 80% of the assessment as determined in accordance with the general rule.

In both cases, the people's government of the municipality of the Old City to which the EDZ or SEZ is related may decide whether or not to levy the local surcharge of 10% or whether to grant a reduction. Where the enterprise in question is an equity joint venture, it must pay the 10% dividend remittance tax.

Dividends, interest, rentals, royalties and income from other sources is usually taxable at the rate of 10% but the people's government has discretion to provide an even lower rate.

Enterprises operating in Old City areas may also benefit from advantages with respect to the *industrial and commercial consolidated tax* (turnover tax) and customs (import) duties. Where they import, as part of the overseas investment, production equipment, office or business equipment, means of transport, office supplies for their own use and building materials, they may apply for an exemption from this tax/duty.

Where items such as raw and other materials, spare parts and packing materials are imported for making products in Old City areas, they are exempt if they are used for products to be exported but subject to normal tax/duty if they are to be sold in China. The sale of finished products is also exempt if exported but subject to the normal tax/duty if sold in China.

Individuals working in Old City areas usually do not benefit from special treatment for purposes of the individual income tax; the same is true with respect to other taxes (e.g. urban real property tax; transport means tax, etc.).

VI. SPECIFIC TAX TREATMENT OF CERTAIN BRANCHES

Certain branches of the Chinese economy enjoy a specific tax treatment. The taxation of State-owned enterprises and, to some extent, of collective enterprises is dealt with in other parts of this article as is the taxation of agricultural undertakings.

There are, of course, some branches of the Chinese economy which because of the very nature of their business may be taxed in deviation from the general rule. One such branch is offshore petroleum exploration and another coal mining. Special treatment is also enjoyed by foreign shipping transport enterprises. These special cases are mentioned here only for the sake of indicating their existence, however they are not dealt with in detail because of the rather limited general utility therein.

VII. TAXATION OF STATE-OWNED ENTERPRISES

1. Introduction

During the first decades of post-revolution China, the figures of State-owned enterprises in China were integrated into the State Budget, i.e. profits were automatically transferred to the budget, and losses were automatically borne by it.

In 1979 the Chinese government initiated the first reform attempts by introducing a profit tax on a selected number of enterprises on an experimental basis.

In 1984, the Ministry of Finance formulated, and the State Council approved and promulgated on 18 September 1984, the "Trial measures for the second step in replacing the transfer of profits by State enterprises with payment of taxes."[10]

This new scheme has generally been applied since 1 October 1984. The following survey of the taxes to which State-owned enterprises are now liable is brief, since their impact on foreign entrepreneurs active in China is either of marginal significance or non-existent. Moreover, there are still a number of open questions concerning the taxation of State-owned enterprises which results in a somewhat "unbalanced" presentation of the different types of taxes.

The prime motive for the introduction of the reform in the field of State-owned enterprises is a substantial increase in efficiency and profitability and, at the same time, a rise in State revenue, as well as a certain degree of "independence" for these enterprises in financial affairs. These motives are achieved through the following:

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[10] Asia Research Bulletin, 30 April 1985, at 1279 B et seq.

(a) *The State-owned enterprise income tax*

To this end a distinction is made between

- *large and medium-sized State-owned enterprises,* subject to income tax at a uniform rate of 55%; and
- *small State-owned enterprises,* subject to income tax at progressive rates ranging from 10 to 55%, divided into 8 brackets.

It should be noted that the State Council recently released regulations under which all *collective enterprises* engaged in industry, service trades, commerce, construction, transport and other trades will be taxed under the same system as small State-owned enterprises.

(b) *The regulatory tax* (also known as the adjustment tax on profits)

For purposes of this tax, there is, again, a distinction made between

- large and medium-sized State-owned enterprises, and
- small State-owned enterprises.

In the case of the former, tax is calculated on the basis of 1983 profits (after income tax), whereby certain adjustments must be made; some of the adjusting elements are those other taxes to which large and medium-sized enterprises may also be subjected, such as the product tax, the value added tax, the business tax and the resources tax. A certain proportion of 1983 retained profits may also be taken into consideration.

In the case of small State-owned enterprises, the regulatory tax is usually not levied. Only in cases where there is excess profit, a "contract fee" may be charged. The determination of regulations to this end may be made by the People's Government of the Province, Autonomous Region or Municipality directly under the control of the Central Government.

Specific rules are established which define what is a "large and medium-sized enterprise" and what is a "small enterprise".

(c) *The resources tax*

Subject to this tax are State-owned enterprises which are active in the exploitation of crude oil, natural gas, coal, ores and other minerals.

At present only crude oil, natural gas and coal appear to be subjected to this tax.

(d) *The product tax*

This tax can be categorized as an excise duty and it is at present levied on, for example, cigarettes.

(e) *The value added tax*

The value added tax is in the process of being gradually introduced and currently applies to only a few machine building industries.

Although no specific details are currently available, it appears that this tax broadly follows the value added tax systems as they are currently found in most countries of Western Europe, i.e. a one-time taxation is safeguarded through effectively taxing only the increase in value by virtue of granting a credit for previously paid value added tax.

(f) *The business tax*

Broadly speaking, the business tax is levied on the income of State-owned enterprises which are active in certain service businesses.

It appears that, at present, the business tax is levied only with respect to the income of certain types of activity, for instance, in the case of State-owned wholesale outlets in the petroleum, chemical, metal, transport and telecommunication industries. No details are currently known as regards the rate, etc. of this tax.

(g) *Other taxes to which State-owned enterprises may be subject*

Apart from those taxes listed above, it appears that State-owned enterprises are also subject to taxes that are generally applicable. These include the

- urban real estate tax;
- city maintenance and construction tax;
- motor vehicles tax;
- salt tax,

as well as other taxes/fees of minor significance, such as the slaughter tax, the oil-burning tax, the architecture tax and the cash-award tax.

2. Summary

It must again be emphasized that the taxation of State-owned enterprises still has the characteristics of trial measures, rather than a system that is based on long-term experience. For instance, it is not always clear as to whether some taxes are levied alternatively or simultaneously, and if the latter is true, whether there is a prescribed sequence in which they are to be levied. This Section on the taxation of State-owned enterprises must therefore be regarded as a very provisional introduction.

VIII. TAX TREATIES CONCLUDED BY CHINA

1. Introduction

Until rather recently, China was not a party to any comprehensive treaty for the avoidance of double taxation although there were some agreements which provided for the avoidance of double taxation with respect to shipping and air transport income.

With the opening of China's economy for foreign investment in the course of the implementation of the "four modernizations", the scene has changed dramatically and to date China is a party to 6 comprehensive tax treaties which are either initialled, signed or have already entered into force.

The following pages offer only a very brief survey of the most important provisions of those tax treaties; they describe the general guidelines rather than the very specific rules contained in the individual tax treaties.

TABLE I
LIST OF TAX TREATIES

Treaty with	*Covers*	*Concluded on*	*Entry into force*	*Applicable as of*	*Official text*
Belgium (not yet available)	—	18 April 1985	*	—	—
Japan	income	6 September 1983	26 June 1984	1 January 1985	Japanese, Chinese, English
France	income	30 May 1984	21 February 1985	1 January 1986	Chinese, French
Germany (Fed. Rep.)	income/ capital	10 June 1985	*	– re withholding taxes on interest and royalties 1 July 1985** – re all other taxes 1 January 1985**	Chinese, German
United Kingdom	income	26 July 1984	23 December 1984	– *In China:* 1 January 1985 – *in U.K.:* 1 April 1985 for corporation tax; 6 April 1985 for income tax and capital gains tax	Chinese, English
U.S.A.	income	30 April 1984	*		Chinese, English

* Not yet in force.
** When ratified, applicable according to Article 30.

2. Provisions of the different tax treaties

Broadly speaking, the tax treaties that have been concluded by China so far follow to a great extent the model conventions of the OECD (1977) and the United Nations (1980), and as far as the treaty with the U.S.A. is concerned, the U.S. model treaty (1981).[11]

(a) Taxes covered[12]

The Chinese taxes covered by the tax treaties are
- individual income tax;
- foreign enterprise income tax, including additional local income tax;
- joint venture income tax, including additional local income tax.

The taxes that are covered in the sphere of the partner states are:

(1) *Belgium:*
- The tax treaty with China was signed on 18 April 1985. However, it is the policy in Belgium not to release information concerning tax treaties before presentation to the Belgian parliament. To our knowledge no information has been supplied by the Chinese authorities so that, to date, no information is available in our Bureau.

(2) *France:*
- income tax (impôt sur le revenu);
- company income tax (impôt sur les sociétés) including any withholding taxes (retenues à la source) and any payments (précomptes) with respect to these taxes.

(3) *Federal Republic of Germany:*
- individual income tax (Einkommensteuer);
- corporate income tax (Körperschaftsteuer);
- capital tax (Vermögensteuer);
- trade tax (Gewerbesteuer).

(4) *Japan:*
- income tax (shotoku zei);
- corporation tax (hojin zei);
- local inhabitant taxes (chiho jumin zei).

(5) *United Kingdom:*
- income tax;
- corporation tax;
- capital gains tax;

(6) *U.S.A.:*
- Federal income taxes.

(b) Territorial scope of China

In the tax treaties so far concluded, the term People's Republic of China is defined as the territory and territorial sea in which the laws relating to Chinese tax are in force.

(c) Permanent establishment

The concept of "permanent establishment" as employed in China's tax treaties closely follows the definition of the OECD Model Convention of 1977 except

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[11] For a comparative study on the model income tax treaties, see: Cees van Raad: Model Income Tax Treaties; Kluwer 1983. For a detailed analysis of the 1980 United Nations Model Convention, see Surrey, Stanley: United Nations Model Convention for Tax Treaties Between Developed and Developing Countries; A description and analysis; IBFD 1980.

[12] It should be noted that only in the treaty with France are Chinese withholding taxes expressly mentioned as being covered under the tax treaty. It appears from the circumstances, however, that they are covered in the other tax treaties too.

where it comes to the time period in the case of a building site or construction or installation project. Here, a permanent establishment is constituted if the underlying undertaking lasts for 6 months and, in this respect, China's tax treaties, as far as they have thus far been concluded, follow the UN Model, rather than the OECD Model, which would establish the time period for building and construction projects at more than 12 months.

Where services are rendered, including consultancy services through employees of an enterprise or other personnel engaged by the enterprise, a permanent establishment is deemed to exist if such activities continue within the country for a period or aggregated periods of more than 6 months within any 12-month period. This provision is included in the treaties with France, the Federal Republic of Germany, Japan and the U.S.A.

The clauses that state what kind of activities do not constitute a permanent establishment, again, closely follow the OECD Model Convention (1977).

(d) Business income

As regards the allocation of the right to tax business income, all tax treaties to which China is a party adopt the general rule of the 1977 OECD Model Convention which prescribes that the profits of an enterprise located in a given State may be taxed only in that State unless that enterprise has a permanent establishment in the other State, in which case the other State may levy a tax on the appropriate portion of the underlying profit.

With respect to the determination of the profit of a permanent establishment, the provisions of the different treaties to which China is a party (except that with Japan) follow the 1980 UN Model Convention which provides for the deductibility of expenses as a general rule but makes certain reservations when it comes to the deduction of certain royalties, fees or other payments.

Moreover, all treaties of China (except that with the United Kingdom) provide for the possibility to calculate the profit of a permanent establishment by applying the fractional apportionment method if that method is customary.

Finally, all treaties also stipulate that no profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise. They also provide that for profits which are dealt with separately under other articles of the pertinent treaty, those articles will take precedence over the article dealing with business profits.

TABLE II

WITHHOLDING TAX RATES

In percent on Chinese-source dividends, interest, royalties and technical fees paid to non-residents (including non-residents of tax treaty countries) where the source of income is not connected with a permanent establishment in China

Country	*Dividends*	*Loan interest*	*Royalties*		*Technical Fees*
			(patent; know-how; trademark; design or model; plan; secret formula or process; copyright of literary, artistic or scientific work, including films and tapes)	(industrial, commercial and scientific equipment)	
under the National law of China (exceptions and allowances not taken into account)	20% (in general) 10% (in case of equity joint ventures)	20%	20%		
under the tax treaty with:					
(1) Belgium	data not yet available				
(2) France	10% (Art. 9)	10%* (Art. 10)	10% on full gross amount (Art. 11)	10% on 60% of gross amount (Art. 11; No. 2 Protocol)	10% on full gross amount (Art. 11)
(3) Germany (Fed. Rep.)	10% (Art. 10)	10%* (Art. 11)	10% (Art. 12)		10% on 70% of gross amount of leasing fee (Art. 12; No. 5 Protocol)
(4) Japan	10% (Art. 10)	10%* (Art. 11)	10% on full gross amount (Art. 12)		
(5) U.K.	10% (Art. 10)	10%* (Art. 11)	10% on full gross amount (Art. 12)	10% on 70% of gross amount (Art. 12)	10% on 70% of gross amount (Art. 13)
(6) U.S.A.	10% (Art. 9)	10%* (Art. 10)	10% on full gross amount (Art. 11)	10% on 70% of gross amount (Art. 11; No. 6 Protocol)	10% on full gross amount (Art. 11)

* Interest received by public bodies or which is guaranteed or insured by a governmental agency is exempt from tax.

(e) Income from immovable property

All treaties to which China is a party follow the usual pattern in allocating the right of taxation to the State in which the immovable property is situated.

(f) Dividends, interest, royalties, technical fees

There are some differences in the tax treaties to which China is a party as regards the taxation of these items but the final results do not deviate too much from each other. Table II provides a simplified overview of the taxes which China may levy on these items of income.

(g) Associated enterprises

All treaties to which China is a party provide for the readjustment of profits in cases of associated enterprises. Article 8 of the treaty with the U.S.A. also contains a clause, used in all three model conventions, which provides for an appropriate adjustment by the relevant Contracting State to the amount of tax charged on profits between associated enterprises.

(h) Capital gains

The taxation (or non-taxation) of capital gains in different countries, i.e. the widely differing concepts with regard to taxing such gains, and, as a consequence, the difficulties in allocating the right to tax in tax treaties is, quite naturally, also reflected in the tax treaties to which China is a party.

The result is that the relevant provisions in the various tax treaties differ considerably. The tax treaty with the United Kingdom simply determines that domestic law is to be applied to capital gains in the State in which they arise whereas the other tax treaties to which China is a party provide for more or less "individualized" allocations of the taxing right according to the category of income within which the capital gains arise.

(i) Independent personal services

All tax treaties to which China is a party define "professional services" in the same way as the 1977 OECD Model and the 1980 UN Model Convention.

There are, however, some deviations as to the allocation of the right to tax, i.e. the tax treaties concluded by China represent a "compromise" between the OECD and the UN Model. Although not perfectly uniform in wording, all tax treaties to which China is a party broadly follow these rules:

- that State in which the person who is exercising the professional services is a resident has the right to tax (general rule); *but*
- where that person
  - has a fixed base regularly available to him in the other Contracting State or
  - is present for a period or periods exceeding, in the aggregate, 183 days in the calendar year in the other State,

  that other State may tax the underlying income attributable to the fixed base/time spent in the other State.

  In calculating the relevant amounts of income, the same principles are usually employed as in the case of business profits.

(j) Dependent personal services

In this respect, all treaties to which China is a party very closely follow the model conventions.

Therefore, the following rules are applicable

- income from dependent personal services is taxable in the State in which the employment is actually carried out (general rule); *but*
- where
  - 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*
  - the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; *and*;
  - the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other Contracting State,

  then remuneration paid to a person resident in a Contracting State for employment exercised in the other State may be taxed in the State in which he is a resident.

The usual exceptions concern directors' fees, pensions, remuneration for government services, remuneration paid to professors and researchers, payments made to students and trainees, as well as remuneration paid in respect of an employment exercised aboard a ship or aircraft operated in international traffic.

(k) Directors' fees

All treaties to which China is a party provide, in conformity with the 1977 OECD Model Convention, for the taxation of directors' fees and similar payments in the country of which the paying company is a resident.

3. Elimination of double taxation

(a) In the People's Republic of China

As far as the elimination of double taxation in China is concerned, i.e. where a resident of China derives income in a treaty country, the picture is rather straightforward and uniform:

- China allows a credit for the foreign tax paid up to the amount of Chinese tax pertaining to that income (direct tax credit).

  However,
- where a Chinese company owns more than 10% of the shares of a company in a tax treaty country, a credit may also be claimed for the foreign tax paid by the subsidiary company on the income from which the dividends are paid (indirect tax credit).

(b) In the other Contracting States

The elimination of double taxation in the countries which are parties to tax treaties with China reflect the pecularities of the tax systems of those countries.

Table III is a simplified survey of the attempt to avoid double taxation in the different treaty countries.

IX. CONCLUSION

With the introduction and application of the tax laws described above, China has taken the necessary steps to implement an economic reform policy which includes, as one of the most important and significant features, the opening of the entrepreneurial field to foreign enterprises.

The tax laws, regulations, etc., of China are distinguishable from those of many other countries through their relative brevity. This brevity must, of course, also mean

TABLE III
PREVENTION OF DOUBLE TAXATION/TAX SPARING

Type of income *Treaty with*	*Business income*	*Income from immovable property*	*Dividends*	*Interest*	*Royalties*
Belgium	Data not yet available				
France	(Art. 7) Exemption with progression clause (Art. 22(2)(a) + (d))	(Art. 6) Exemption with progression clause (Art. 22(2)(a) + (d))	(Art. 9) Tax sparing credit (a) 10% of gross amount for dividends of joint ventures (b) 20% of gross amounts for other dividends (Art. 22(2)(c))	(Art. 10) Tax sparing credit: 10% of gross amount of interest (Art. 22(2)(c))	(Art. 11) Tax sparing credit: 20% of gross amount of royalties (Art. 22(2)(c))
Germany (Fed. Rep.)	(Art. 7) Exemption with progression clause (Art. 24(2)(a) sentence 1)	(Art. 6) Exemption with progression clause (Art. 24(2)(a) sentence 1)	(Art. 10) (a) exemption if German corporation directly holds at least 10% of capital in Chinese corporation ("affiliation privilege") (b) Tax sparing credit of 10% of gross amount for other dividends Art. 24(2)(a) and 24(2)(c), respectively)	(Art. 11) Tax sparing credit: 15% of gross amount of interest (Art. 24(2)(b) + (c))	(Art. 12) Tax sparing credit: 15% of gross amount of interest (Art. 24(2)(b) + (c))
(**Note:** Germany has reserved the right to apply some treaty provisions only to income which is derived from "active undertakings" in China, i.e. entrepreneurial activities actually maintained in China ("activity clause").)					
Japan	(Art. 7) Direct tax credit, or, in case of tax incentives provided by China, tax sparing credit (Art. 23(2), and Art. 23(4), respectively)	(Art. 6) Direct tax credit (Art. 23(2))	(Art. 10) (a) indirect tax credit if Japanese corporation holds not less than 25% in Chinese corporation (b) tax sparing credit (i) 10% for dividends of joint ventures, (ii) 20% for other dividends (Art. 23(2)(b), and Art. 23(3), respectively)	(Art. 11) Tax sparing credit: 10% of interest (Art. 23(3))	(Art. 12) Tax sparing credit: 20% of royalties (Art. 23(3))
United Kingdom	(Art. 7) Direct tax credit, or, in case of tax incentives provided by China; tax sparing credit, subject to a maximum of 10 years (Art. 23(2), and Art. 23(3), respectively)	(Art. 6) Direct tax credit (Art. 23(2))	(Art. 10) (a) indirect tax credit if U.K. corporation holds at least 10% in Chinese corporation (b) direct tax credit, or, in case of tax incentives provided by China, tax sparing credit, subject to a maximum of 10 years (Art. 23(2)(b), and Art. 23(2)(a) and Art. 23(3), respectively)	(Art. 11) Direct tax credit, or, in case of tax incentives provided by China, tax sparing credit, up to 15% of the interest, subject to a maximum of 10 years (Art. 23(2), and Art. 23(3), respectively; domestic law)	(Art. 12) Direct tax credit, or, in case of tax incentives provided by China, tax sparing credit, subject to a maximum of 10 years (Art. 23(2), and Art. 23(3), respectively)
U.S.A.	(Art. 7) Direct tax credit (Art. 22(2))	(Art. 6) Direct tax credit (Art. 22(2))	(Art. 9) (a) indirect tax credit if U.S. corporation holds at least 10% in Chinese corporation (b) direct tax credit (Art. 22(2)(b), and Art. 22(2)(a))	(Art. 10) Direct tax credit (Art. 22(2))	(Art. 11) Direct tax credit (Art. 22(2)
(**Note:** In an exchange of notes, the U.S.A. has agreed to amend this tax treaty if the U.S. accepts the inclusion of tax sparing credits in a tax treaty with any other country)					

that the legislation cannot be thorough in all respects.

Attempting to summarize the tax system as it has evolved in recent years, two major observations may be noted:

1. Because of its brevity, it is relatively easy for an experienced tax expert to familiarise himself/herself with the principal guidelines of that system;
2. Because of the gaps which still exist in the tax legislation and the lack of experience in application, especially in the international sphere and thus in undertakings with foreign participation, it is necessary to clarify rather vague points in the contracts, etc., through which any entrepreneurial cooperation with a Chinese organization is established.

As far as the negotiation of tax treaties is concerned, the Ministry of Finance in Beijing is in discussion with many countries with a view to expanding the tax treaty network, which currently consists of six comprehensive tax treaties, as outlined above.

China has in recent years initiated and enacted a considerable number of tax laws and regulations, and has concluded or is in the process of concluding tax treaties. The international tax community is following these developments with great interest since both the national and international aspects of taxation are very important components of the economic development of a country and of the economic cooperation amongst nations.

APPENDIX

List of legislation in the field of investment and taxation currently in force in China[13]

(1) Income tax: individuals and enterprises
(2) Taxes on property or wealth
(3) Taxes on transfer of capital
(4) Registration and licence duties
(5) Taxes on goods and services and customs duties
(6) Taxes on payroll
(7) Others
  (a) Company laws and related legislation
  (b) Joint Venture Law and pertinent Regulations
  (c) Legislation re special Economic Zones (SEZs)
    (i) Guangdong Province
      - General
      - Shenzhen SEZ
      - Zhuhai SEZ
      - Shantou SEZ
    (ii) Fujian Province
  (d) Legislation re Economic Development Zones (EDZs)
  (e) Legislation on Representative Offices
  (f) Legislation on Activities of Specific Branches
    (i) Offshore oil industry
    (ii) Banking
    (iii) International civil aircraft
    (iv) Foreign vessels
  (g) Legislation on banking and exchange control
  (h) Legislation on trade
  (i) Legislation on patents, trademarks, copyrights

(1) *Income tax: individuals and enterprises*

- Provisional Regulations concerning Industrial and Commercial Income Tax of 19 December 1950, as amended.
- Regulations governing the Agricultural Tax of 3 June 1958, as amended.
- Regulations for Taxation on the Transportation Income of Vessels of Foreign Nationality, of 21 June 1974, as amended.
- Individual Income Tax Law of the People's Republic of China, of 10 September 1980 (see also 7(f)(iv)).
- Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment, of 10 September 1980 (see also 7(b)).
- Regulations for implementing Individual Income Tax Law, of 14 December 1980.
- Detailed Regulations for implementation of the Income Tax Law concerning Joint Ventures, of 14 December 1980.
- The Foreign Enterprise Income Tax Law, of 18 December 1981.
- Provisional Regulations Regarding the Reduction and Exemption of Income Tax on Fees for the Use of Proprietary Technology, of 13 December 1982.
- Detailed Rules and Regulations for the Implementation of the Foreign Enterprise Income Tax Law, of 17 February 1982.
- Provisional Regulations Regarding the Reduction and Exemption of Income Tax Relating to Interest Earned by Foreign Businesses from China, of 7 January 1983.
- Provisional Regulations concerning the Income Tax on State Enterprises, of 25 July 1983.
- Decision of the Standing Committee of the National People's Congress on the revision of the Income Tax Law concerning chinese-foreign joint ventures, of 2 September 1983.
- Interim Provisions concerning the Reduction of an Exemption from Enterprise Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and Fourteen Coastal Port Cities, of 15 November 1984 (entry into force: Income tax: 1 January 1984; Industrial and Commercial Consolidated Tax: 1 December 1984) (see also 7(c) and 7(d)).
- Some Provisions of the People's Republic of China Concerning the Reduction of or Exemption from Income Tax in the Absorption of Foreign Funds.
- Interim Provisions for Collection of Industrial and Commercial Consolidated Tax and Foreign Enterprise Income Tax from Permanent Representative Offices of Foreign Enterprises in China, of 14 May 1985 (see also (5) and (7e)).

(2) *Taxes on property or wealth*

- Provisional Regulations for the real property tax on urban buildings, of 8 August 1959, as amended.

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[13] *Source:* Investment and Taxation in the People's Republic of China, 5th Edition, IBFD Amsterdam 1985. A great number of Laws, Regulations, etc. have been released recently, especially at the provincial level. Although great care has been taken to present this list in the most up-to-date manner, it cannot be guaranteed complete as of the date of publication.

- Provisional Regulations of the City Maintenance and Construction Tax, of 8 February 1985.

(3) *Taxes on transfer of capital*

None.

(4) *Registration and licence duties*

- Provisional Regulations for the slaughter tax, of 19 December 1950, as amended.
- Provisional Regulations for the licence tax on vehicles and ships, of 13 September 1951, as amended.

(5) *Taxes on goods and services and customs duties*

(a) *Taxes on goods and services*

- Regulations and detailed rules for the industrial and commercial consolidated tax, of 13 September 1958, as amended.
- Rules Concerning the Levy and Exemption of Customs Duties and Consolidated Industrial and Commercial Tax on Imports and Exports for the Chinese-Foreign cooperative Exploitation of Offshore Petroleum, of 28 February 1982 (see also 7(f)).
- Rules of the Ministry of Finance and the General Administration of Customs Concerning the Levy and Exemption of Customs Duties and Consolidated Industrial and Commercial Tax on Imports and Exports for the chinese-foreign Cooperative Exploitation of Offshore Petroleum, of 1 April 1982 (see also 7(f)).
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- Interim Provisions for Collection of Industrial and Commercial Consolidated Tax and Foreign Enterprise Income Tax from Permanent Representative Offices of Foreign Enterprises in China, of 14 May 1985 (see also (1) and (7e)).

(b) *Customs duties*

- Provisional Regulations Governing the Customs Import and Export Tariffs, of 4 May 1951, as amended.
- Provisional Rules Governing the Levying of Tonnage Dues of the Customs of China, of 19 September 1952.
- Rules Governing the Supervision and Control of International Civil Aircraft by the Customs of the People's Republic of China (1 October 1974) (see also 7(f)).
- Rules Governing the Supervision and Control of the Importation of Goods for Exhibition by the Customs of the People's Republic of China (3 November 1975).
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- Rules of the Customs General Administration, the Ministry of Finance and Ministry of Foreign Economic Regulations and Trade Concerning the Supervision, Control, Taxation and Exemption of Imports and Exports of Chinese-Foreign Joint Ventures, of 30 April 1984.
- Regulations concerning Import and Export of Articles by Resident Offices and their Staff, of Foreign Enterprises and Press in China, of 1 May 1984.

(6) *Taxes on payroll*

None.
(See, however, Individual Income Tax Law and Regulations at (i) above.)

(7) *Others*

(a) *Company laws and related legislation*

- Economic Contract Law of the People's Republic of China, of 13 December 1981.
- Rules for the Implementation of Exchange Control Relating to Enterprises with Overseas Chinese Capital, Enterprises with Foreign Capital, and Chinese and Foreign Joint Ventures, of 19 July 1983 (entry into force: 1 August 1983) (see also 7(g) and 7(b)).
- Regulations of the People's Republic of China on Contracts Relating to Property Insurance, of 1 September 1983.
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- Regulations of the People's Republic of China on the Arbitration of Disputes over Economic Contracts.

(b) *Joint Venture Law and Pertinent Regulations*

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tures using Chinese and Foreign Investment, of 26 July 1980.

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- Provisional Regulations of the General Administration of Industry and Commerce on the standards of registration to be paid by joint ventures using Chinese and foreign investment, of 2 February 1982.
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- Procedures for the Implementation of the Provisions for Labour Management in Joint Ventures Using Chinese and Foreign Investment of 19 January 1984.

(c) *Legislation re Special Economic Zones (SEZ)*

(i) Guangdong Province

- Generally applicable
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  - Provisional Regulations on Registration of Enterprises in Special Economic Zones, of Guangdong Province of 17 November 1981 (entry into force: 1 January 1982).
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  - Interim Provisions Concerning The Reduction Of And Exemption From Income Tax and Consolidated Industrial And Commercial Tax in The *Special Economic Zones* and Fourteen Coastal Port Cities, of 15 November 1984 (entry into force: Income Tax: 1 January 1984; Industrial and Commercial Consolidated Tax: 1 December 1984) (see also 1 and 4(a)).
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(ii) Fujian Province

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- Provisional Regulations for the Establishment of Representative Offices in China by Overseas Chinese and Foreign Financial Institutions, of 1 February 1983 (entry into force: 1 February 1983) (see also 7(f) and 7(g)).
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(f) *Legislation on Activities of Specific Branches*

(i) Offshore oil industry

- Regulations of the People's Republic of China on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises, of 30 January 1982.
- Rules Concerning the Levy and Exemption of Customs Duties and Consolidated Industrial and Commercial Tax on Imports and Exports for the Chinese-Foreign Cooperative Exploitation of Offshore Petroleum, of 28 February 1982 (see also 5).

(ii) Banking

- Provisional Regulations for the Establishment of Representative Offices in China by Overseas and Foreign Financial Institutions, of 1 February 1983 (see also 7(e) and 7(g)).

(iii) International civil aircraft

- Rules Governing the Supervision and Control of International Civil Aircraft by the Customs of the People's Republic of China (1 October 1974).

(iv) Foreign vessels

- Regulations Governing Supervision and Control of Foreign Vessels by the People's Republic of China (22 August 1979).
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(g) *Legislation on banking and exchange control*

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- Provisional Regulations for the Establishment of Representative Offices in China by Overseas Chinese and Foreign Financial Institutions, of 1 February 1983 (see also 7(e)).
- Rules for the Implementation of Exchange Control Regulations Relating to Enterprises with Overseas Chinese Capital, Enterprises with Foreign Capital, and Chinese and Foreign Joint Ventures, of 19 July 1983 (entry into force: 1 August 1983) (see also 7(a) and 7(b)).
- Regulations of the Bank of China for Foreign Currency Deposits (Category A and Category B), and for Special Deposits of Renminbi, of 18 November 1983 (entry into force: 18 November 1983).

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- Details Concerning the Export Licence System Governing Eleven Categories of Export Commodities, of 22 January 1972 (entry into force: 1 February 1982).
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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-52 of the January 1985 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Der Verfasser stellt zunächst in kurzer Form die Geschichte des japanischen Steuersystems vor. Danach beschäftigt er sich in detaillierter Form mit den Änderungen, die seit dem II. Weltkrieg durchgeführt wurden. Obwohl das gegenwärtige japanische Steuersystem seinen Ursprung in den Vorschlägen hat, die seinerzeit von Prof. Carl S. Shoup vorgelegt worden waren, wurden zwischenzeitlich doch eine Reihe von Ergänzungen eingeführt, womit das Steuersystem besser an das spezifisch-japanische Wirtschafts- und Sozial-"Klima" angepasst werden konnte. Die Steuerkommission, die den Ministerpräsidenten berät, spielte und spielt bei Fragen der Revision japanischer Steuergesetze immer (noch) eine wichtige Rolle.

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Grossbritannien: Auf der Suche nach der fiskalen Neutralität bei der steuerlichen Behandlung der Ersparnisse *447*

Der Verfasser vertritt die Auffassung, dass das Ziel der fiskalen Neutralität in der Behandlung von Ersparnissen weithin als ein wünschenswertes Ziel akzeptiert wird. Es zeigte sich aber, dass sich die Eliminierung aller Steuerbefreiungen als politisch nicht durchsetzbar erwiesen hat. Noch stets bietet sich aber der Weg einer *persönlichen Ausgabensteuer* an, und es scheint insgesamt nicht ausgeschlossen zu sein, dass eine solche Steuer eines Tages auch eingeführt werden könnte.

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Kanada: Zum Haushalt 1985-86; Geschäftszweck und Vorabauskünfte; Entwicklungen auf dem Gebiet der Doppelbesteuerungsabkommen *452*

Die Kanadier werden sich schon in der nahen Zukunft mit einer höheren Steuerbelastung konfrontiert sehen. Die Besteuerung der Gewinne aus der Veräusserung von Vermögen wird sich allerdings ermässigen, und für bestimmte Investitionen wird es Erleichterungen geben. Die Entscheidung im *Fall Stubart*, wo festgestellt wurde, dass ein mangelnder Geschäftszweck nicht ausreichend ist, um eine Transaktion als nichtbeachtlich zu behandeln, wird in Zukunft die Grundlage für Vorabauskünfte bilden. Das Doppelbesteuerungsabkommen mit Südafrika könnte möglicherweise gekündigt werden; ein Doppelbesteuerungsabkommen mit der Sovietunion wurde unterzeichnet.

Donald R. Huggett:

Durchsuchung und Beschlagnahme – Ein Chaos von Bestimmungen bezüglich der Kompetenzen der Steuerbehörden *456*

Der Verfasser bespricht die Kompetenzen der Steuerbehörden in Grossbritannien, den U.S.A. und Kanada im Zusammenhang mit der Frage, welche Informationen diese von den Steuerpflichtigen und von solchen Personen verlangen können, die über diesbezügliches Wissen und über die entsprechenden Unterlagen verfügen. Er geht dabei auch auf die Probleme ein, denen sich Anwälte und Steuerberater in dieser Beziehung gegenübergestellt sehen.

Michel Lecerf:

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Besprechung der neuen 10%-igen Quellensteuer, die auf Zahlungen erhoben wird, die an ausländische natürliche Personen und Gesellschaften für die Erbringung bestimmter Dienstleistungen in Gabun erhoben wird.

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L'auteur considère que la recherche de neutralité fiscale dans le traitement de l'épargne est largement souhaitée, l'élimination de toutes les exemptions fiscales est toutefois considérée comme politiquement inacceptable. L'imposition des dépenses personnelles reste une possibilité à envisager et introduire dans le futur.

Allan R. Lanthier:

Canada: Budget 1985-86; objectifs économiques et réglementation anticipée; développements internationaux *452*

Les Canadiens devront à l'avenir supporter une charge fiscale plus lourde, il faut toutefois noter un allègement de l'imposition des plus-values et la possibilité d'une exemption en faveur de certains investissements. La décision prise dans l'Arrêt Stubart, considérant le manque d'objectif économique insuffisant pour ignorer une transaction, sera appliqué lorsequ'il s'agit de réglementation anticipée. La convention fiscale avec l'Afrique du Sud pourrait être dénoncée, par contre une telle convention a été signée avec l'URSS.

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ERRATUM

In the article by Dr. Linda Low, *The financing process in the public sector in Singapore* (39 BIFD 4 (1985)), Table 2 at 151 should read as follows:
- the subtotal for 1967 is 393.4 (and not 293.7);
- the subtotal for 1975 is 1,904.9 (and not 1,673.9); the ratio under Subtotal/Total revenue is 61.6 (and not 54.1);
- the subtotal for 1976 is 2,043.8 (and not 2,042.9);
- the subtotal for 1977 is 2,253.2 (and not 2,255.0);
- the subtotal for 1978 is 2,368.0 (and not 2,364.2);
- the subtotal for 1979 is 2,662.5 (and not 2,659.5).

A Survey of the Japanese Tax System[1]

by Torao Aoki

Mr. Torao Aoki is Professor of Public Finance at Niigata University and Visiting Professor at De La Salle University, Manila, Philippines.

I. HISTORICAL BACKGROUND

1. Before World War II

When Japan emerged as a modern state after the Meiji Restoration of 1868, the land tax accounted for more than 80% of the total tax revenue of the national Government. With the advent of the capitalist economy, in 1887 Japan became one of the first states to initiate a national income tax. Under the schedular income taxation in 1899, the income tax was extended to corporations. Around the turn of the century, the liquor tax and other indirect taxes were established. In 1904, the production and sales of cigarettes and tobacco products were brought under the monopoly of the Government, which lasted until March 1985.[2]

After World War I, the income tax was completely revised. By that time the revenue from income tax, including both corporate and personal taxation, as a percentage of the total tax revenue exceeded 20% while those from the land tax fell below 10%. Later in 1938, the predecessor of the commodity tax was introduced. On the eve of the Pacific War, a far-reaching reform of the tax system was put into effect. The former income tax was divided into the income tax (on natural persons) and corporation tax. Since then, in Japan, the term "income tax" means only the tax imposed on individuals under the Income Tax Law and the term "corporation tax" means the one on income of corporations under the Corporation Tax Law. The new income tax was featured by the bipolar system, which employed schedular taxes and the graduated global tax. Withholding tax at source which had been hitherto applied to interest and dividends was expanded to wages and salaries. The corporation tax was imposed on corporate profits at a flat rate. The share of the direct tax revenue in the total national tax revenues rose from 34.8% in 1934 to 36 average to 65.1% in 1941.

2. After World War II

Immediately after World War II, various taxation measures were taken to curb inflation and to reorient the economy. The property tax with highly progressive rates was introduced. In 1947, the bipolar system of income taxation was replaced by the purely global tax with progressive rates and the American "self-assessment" system superseded the traditional method of Government assessment and collection. Some national taxes such as land and business taxes were transferred to local governments. For a brief period from 1948 to 1949, the turnover tax was put in force.

In 1949 and 1950, a mission headed by Carl S. Shoup, Professor of Economics at Columbia University, visited Japan to recommend a vast restructure of the Japanese tax system. The Shoup proposals, which were incorporated in the 1950 tax revision, placed direct taxes, especially income and corporation taxes, in the center of the whole tax structure. The income tax with the maximum rate lowered, was complemented by the net worth tax. A quarter of the dividends received by shareholders were credited against their income tax and inter-company dividends were exempted from the corporation tax. On the other hand, a surcharge was levied on undistributed corporate profits. The tax reforms based on the recommendations of the Shoup Mission were later modified so as to better fit the Japanese economic and social climate, with the income tax dominating. For instance, in 1953, the net worth and accession taxes were abandoned, and capital gains from the sales of securities were removed from the income tax base. The enforcement of the value-added tax incorporated in the Local Tax Law was postponed several times and eventually repealed in 1954 without ever having gone into effect.

In 1956, a Tax Commission was created as an advisory organ to the Prime Minister for the purpose of fundamentally reviewing the structure and adapting the current structure to the new economic conditions. Since then, the tax revisions of each year have been worked out on the basis of the reports of the Commission. In the second half of the 1950s, thanks to the fast growth of the Japanese economy, the tax revenues were much larger than originally estimated every year. Under the circumstances, tax was successfully reduced mainly by raising the exemption and deduction and by mitigating the progressiveness of income tax rates. As a result of a series of reductions in direct taxes, the share of the indirect taxes in the total tax revenue was on the rise. The burden of the indirect tax was allegedly heavy on those with incomes below the taxable minimum since they did not benefit from the direct tax reductions. In 1961, the Commission proposed more appropriate rates of indirect tax.

In the meantime, the corporation tax also underwent some changes in deviation from the philosophy that the corporation was deemed to be a mere aggregate of shareholders not constituting an independent taxable entity. In 1955, a separate tax rate applicable to smaller

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[1] This is an abridged version of a chapter to appear in *Tokue Shibata* ed., *Public Finance in Japan* (University of Tokyo Press) (1985).

[2] Effective 1 April 1985 the Government monopoly with respect to cigarettes and tobacco was discontinued. The former Government corporation was transformed into the Japan Tobacco Inc. which is a private company. As to Government revenue, monopoly profits have been replaced by the tobacco consumption tax.

companies with profits below a certain amount was established. In 1961, a split rate system between the retained and distributed profits was introduced, as in some European countries, with a view to encouraging corporations to raise their own equity capital. In 1962, the general Law of National Taxes came into force. This provides for general principles and basic rules of taxation, such as the principle of attribution of income to an actual beneficiary,[3] procedures for tax assessment and payment and for the claim or suits for tax disputes and penalties.

In 1965, for the first time after the war, the Government issued bonds to finance the budget deficit. Since then the tax policy was expected to play a counter-cyclical role. Thus in the following year, tax reductions were made on an unprecedentedly large scale. In its report of 1968, the Tax Commission suggested reviewing the nature of corporations for taxation purposes and studying the general sales tax on value-added in the future. The 1969 amendment of tax on land represented an effort to facilitate the supply of land on the one hand and to forestall speculation on the other. Long-term capital gains from land were taxed at reduced rates. A variety of special tax measures was adopted for policy purposes, such as social development, housing, pollution control, energy development and promotion of small businesses.

While the reduction in the income tax was pursued according to the long-range policy, the tax rates on corporations were raised in 1970 for the first time in 18 years. In the 1970s, the Japanese economy turned from one of fast growth to one of slow growth. It was hard hit by the international monetary turmoil of 1971 and the oil crisis of 1974. The income tax was cut first as an anti-recession measure and later for anti-inflation purposes while the corporation tax rates were further increased in 1974.

Due to the economic recession, however, the tax revenues in fiscal year 1975 decreased by 8% from the previous fiscal year as against the 35% gain during FY 1973.

As a result, the tax revenues for FY 1975 fell short of the original budget estimate of 17,545 billion yen (US$ 79,750 million) by nearly 3,900 billion yen (US$ 17,730 million). In 1976, the government suspended the annual income tax cut which had been made possible by the revenue surplus due to the rapid economic growth. Since 1976, the special taxation measures have been drastically curtailed and the indirect taxes were raised for selected items.

3. Recent developments

In the absence of any major income tax reduction, the share of direct taxes in the total national tax revenues increased finally to exceed 70% in 1980, leaving no room for increase in direct taxes. In its report of October 1977 on the medium-range tax policy, the Tax Commission proposed "a new tax on consumption on a broad tax base". In December of the following year, the Commission published a draft outline of the general consumption tax which was a kind of value-added tax. However, the proposed new tax proved not to be feasible politically and otherwise at a time when the Provisional Commission for Administrative Reform created in March 1981 set forth "the goal of the fiscal restructure without tax increases".

In order to reduce the deficit-covering government bonds, efforts are made to curtail the budget expenditures on the one hand and to explore revenue sources, on the other hand. For this purpose, some of the special tax incentive measures were scrutinized and abolished. The 1980 tax legislation introduced a "Green Card System" to prevent abuse of the exemption for interest on "small" savings of identifying the depositors. This System was scheduled to come into effect as of January 1984 but enforcement has been postponed by 3 years. In 1985, the System was eventually abolished and, instead, control over the enforcement of tax treatment of interest on savings was tightened.

In 1981, the rates of corporation tax were further raised and the stamp tax, liquor tax and commodity tax were increased. Since 1982, a variety of revisions have been made to strengthen taxation on business and enterprise. By international standards, the income tax burden in Japan was by no means heavy. But taking into consideration the trends of income and prices the second largest cut in the income tax was carried out from the end of 1983 to 1984. The taxable minimum income was considerably raised and adjustment was made in the progressiveness by changing tax rates and brackets. To partly offset the revenue loss due to the income tax reduction, the rates of corporation tax were further increased while some tax incentives were provided for investments.

At the very outset of the self-assessment system for income tax in 1947, it was intended to make the keeping of accounting records and bookkeeping obligatory. This was also incorporated in the Shoup Recommendations and the report of the Tax Commission on the General Law of National Taxes of 1961. But enforcement was always considered premature. Only the taxpayers qualified to file a "blue return"[4] introduced in 1950 are required to keep at least a minimum set of accounting records. Now that the business skills of small business have improved, in the interest of better compliance such bookkeeping was made compulsory in 1984 for all individual taxpayers with business, real estate or timber income.

II. SALIENT FEATURES OF THE JAPANESE TAX SYSTEM

1. International comparison

As indicated in the OECD Revenue Statistics, Japan raises a little over 40% of the total tax revenue, both national and local, from individual and corporate taxes

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[3] The principle of *attribution of income to an actual beneficiary* denotes that income is attributed to the actual beneficiary and not to the person who acts as an intermediary in receiving such income, such as an agent or a nominee.

[4] The blue *return system* is intended to improve the taxpayers' bookkeeping practice and to encourage compliance. Individuals or corporations who file blue color tax forms (and not the regular white forms) with the approval of the tax authorities are entitled to certain tax privileges but they are required to keep proper financial records.

Table 1
Tax revenue of main headings as percentage of total tax, 1982 or 1983
(in %)

	Japan		*United States*		*United Kingdom*		*F.R. of Germany*		*France*		*Italy*	
Income and profits		45.0		44.8		38.1		33.6		18.1		32.0
Individual	25.3		37.8		29.4		28.9		13.7		24.4	
Corporate	19.7		7.0		9.9		4.6		4.4		8.0	
Social security		30.4		27.7		18.1		35.7		43.7		41.2
Payroll		—		—		1.3		—		2.2.		—
Property		8.9		10.1		13.0		3.4		3.7		3.0
Goods and services		15.4		17.5		29.4		27.3		29.0		16.5
Others		0.3		—		—		0.0		3.2		1.4
Total		100		100		100	100	100	100	100		100

Sources: Organization for Economic Co-operation and Development, *Revenue Statistics of OECD Member Countries 1965-1983*, Paris, 1984, pp. 82, 89, 190 and 191.

Remarks: 1. Details do not add to the totals because of rounding.
2. Includes national and local taxes.
3. The figures for Japan, the U.S. and Italy are for 1982 and others are provisional for 1983.

(see Table 1). The share of these taxes is 46% in the United States and less than 40% in other industrialized countries. The revenue from taxes on goods and services as a percentage of the total tax revenues in Japan is about 15%, which is close to some 17% of the U.S. but almost half of those of the European countries. To this extent, the Japanese tax structure is more like that of the U.S. than those of the Western European countries. Incidentally, in Japan social security contributions, accounting for 30% of the total tax revenues mentioned above are not incorporated in the general budget and, hence, are treated separately from the tax regime.

Wages and salaries, interest, dividends, royalties and payments to non-residents are subject to withholding tax at source. Nearly 80% of the income tax, the single largest tax item accounting for almost 40% of the total national tax revenue (hereinafter, "the total revenue" only refers to the national taxes unless otherwise mentioned), is collected in this way. Far more important than in other countries is the corporation tax, which ranks second, contributing about 30% of the total tax revenues in Japan. There is no tax on capital, no wealth tax or general consumption tax such as value-added tax and sales tax. Like those of other industrialized nations, the Japanese custom duties are protective tariffs as against revenue tariffs, accounting for less than 2% of the total tax revenue. Manufacture and sale of tobacco and tobacco products were monopolized by the government corporation for fiscal purposes until March 1985.

2. Tax structure

For fiscal year 1985 ending in March 1986, the estimated revenue of national taxes is about 39,494 billion yen and projected revenue of local taxes is around 23,164 billion yen. Thirty-two percent of the revenue from the major national taxes, i.e. income, corporation and liquor taxes, and all or part of the taxes somewhat related to roads are transferred to local governments as grants-in-aid. Tax revenue finances 74.3% of the total expenditure in the general account of the national Government totalling 52,500 billion yen in fiscal 1984. The contribution of the tax revenue to total Government receipts reached 86.2% in FY 1970 but sharply declined to 58.9% in FY 1977. The profits from government monopoly as a percentage of the total national receipts which steadily fell from 20.1% in FY 1948 to 1.6% in FY 1975, is 2.0% for FY 1984, when such monoply was discontinued.

Before the war – i.e. from 1934 to 1936 – the shares of direct and indirect taxes in the total revenue averaged 35% and 65%, respectively. This trend was reversed after the war (see Table 2). In the 1980s, Japan derived more than 70% of the tax revenue from direct taxes. Except for the extreme case of the U.S., the share of both types of taxes is by and large equal in other industrialized countries. This heavy reliance on direct taxes is giving rise to a variety of problems in Japan. Table 4 bears out that the overall tax burden of the Japanese people as measured by gross domestic product is rather light. Nevertheless, because of direct taxes taxpayers feel their tax burden is onerous. Although Japan has a fairly sophisticated tax administration it is extremely difficult to convince taxpayers in every walk of life that they receive equal treatment in direct taxes.

3. Income tax

The income tax is a global tax, under which most income items are aggregated and taxed at highly progressive rates. The income tax is collected by either withholding at source or by filing a self-assessed tax return for income derived during a calendar year. Individuals are also subject to prefectural and municipal taxes. For the purpose of tax computation, incomes are classified into ten categories, such as interest, dividends, business income, employment income and capital gains.

Tax on wages and salaries is withheld at source and adjustment between the amount withheld and final tax liability is made at the last payment of such wages and salaries during the year. Thus, the majority of wage and salary workers are not required to file a tax return. Remunerations or fees are subject to withholding tax at the rate of 10% up to one million yen and 20% for over one million yen. The rate of withholding tax on income from interest and dividends is 20%. But under the Special Taxation Measures Law, until the end of 1986, taxpayers may elect to be taxed at 35% without adding such receipts to the aggregate income in their tax returns. Also under the same Law, interest income from bank deposits, postal savings and government bonds with principal value of not over 3 million yen is exempt from tax. To partly avoid the economic double taxation, a dividend credit of 10 or 5% is allowed against income tax for taxpayer's income of up to 10 million yen or more.

For business income, wages paid to family employees may be deducted as necessary expenses within certain limits. The taxpayers filing a blue return are granted a more liberal deduction of wages for family employees, a special deduction, various tax-free revenues, such as those for bad debts and price fluctuations, and accelerated depreciation allowances. From 1974 to 1988, a proprietor filing a blue return may elect to be treated as a corporation for taxation purposes. He may deduct his own remuneration to which the special deduction for employment income then applies. The "deemed corporation income" thus obtained is taxed at the rate of 27.3% and for that part of income which exceeds 8 million yen at 37.5%.

Receipt of severance payments and income from the sale of timber, for which special deductions are available, are taxed separately from other incomes. A special deduction of 500,000 yen is applicable to capital gains. For capital gains on property owned for over 5 years, only half of the amount after applicable deductions is taxable as long-term capital gains. Capital gains are added to the aggregate income. However, under the Special Taxation Measures Law, capital gains on land or buildings are taxed separately from other income in principle at the rate of 20 or 40% on the long or short-term gains, according to a somewhat sophisticated formula. Income from the sale of stock shares is exempted from tax unless it involves more than 50 transactions totalling 200,000 shares during the year.

All income, except the above-mentioned types of income, is aggregated. To be subtracted from this income amount is 330,000 yen each for the basic exemption, exemption for spouse and each dependent. An additional exemption is available for a handicapped or aged person (65 years or older), widow, widower or working student. Taking these personal exemptions into account, a family of four with an income of less than 2,357,000 yen is exempt from the national income tax. According to the estimates of the Japanese Ministry of Finance, this minimum taxable income compares favorably with 1,863,000 yen in the U.S., 984,000 yen in the United Kingdom, 1,158,000 yen in the Federal Republic of Germany and 2,151,000 yen in France (early 1985).[5] Allowable deductions are social insurance premiums and for casualty loss, medical expenses, life insurance premiums, fire and casualty insurance premiums and contributions or donations up to a certain amount.

The income tax is graduated into 15 rate brackets from 10.5% for taxable income of 500,000 yen or less to 70% for income of over 80 million yen. To alleviate the burden of progressive tax rates, income averaging may be used for income from sale of timber and fluctuating extraordinary income. The amount of tax which would apply to only one-fifth of such income is determined and then multiplied by 5 to arrive at the total tax due. A certain percentage of dividends received as mentioned before, foreign income taxes and a certain part of house mortgage repayment may be credited against income tax.

Taxpayers must file a tax return by March of the next year. Persons whose income is not subject to withholding tax each pay one-third of their income tax estimated on the basis of the preceding year's tax by 31 July and 30 November of the taxable year. It is commonly alleged that the proprietor of small or medium sized business can minimize tax liability, taking advantage of the accounting practices and tax privileges and that farmers substantially understate their income for tax purposes. In contrast, total payments to salaried workers are subject to withholding tax as they are earned. Statistics show that in FY 1982, 88.4% of all the wage and salary earners paid the national income tax, while 39.5% of those engaged in business and only 14.6% of farmers paid such taxes.

Since 1950, taxation offices post lists of high-income tax returns, which receive wide publicity throughout Japan. The minimum amount to be posted has been raised over the years. Until 1983, persons whose annual taxable income was more than 10 million yen (about US$ 45,000) were put on the lists. From 1984, only those who paid more than 10 million yen in taxes are listed. Therefore, the number of persons on the list sharply fell from 520,000 for 1982 to 66,000 for 1983.

4. Corporation tax

The corporation tax ranks second, after the individual income tax, in the national tax. The revenues from corporation tax exceeded those from income tax between FY 1957 and FY 1974 except for several years when the former levelled off due to business recession. Estimated at 31.8% for FY 1985, the receipts from corporation tax as a percentage of the total tax revenues are far greater than in other industrialized countries. The comparable figures for 1983 were 9.8% in the U.S., 6.9% in the U.K., 6.9% in the Federal Republic of Germany,

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[5] Exchange rates employed are 242 yen for U.S. dollar, 312 yen for Pound Sterling, 83 yen for Deutsche mark and 27 yen for French franc.

Table 2
Components of national taxes
(In percent)

Fiscal years	*1934 to 36*	*1950*	*1960*	*1970*	*1975*	*1980*	*1984*[a]	*1985*[b]
Direct taxes of which:	34.8	54.9	54.3	66.0	69.3	71.1	41.4	73.4
Income tax	11.4	38.6	21.7	31.2	37.8	38.1	38.1	39.2
Withheld		22.3	16.3	22.2	27.3	29.0	29.9	31.3
Returns		16.2	5.4	9.0	10.5	9.0	8.3	7.9
Corporation tax	9.5	14.7	31.8	33.0	28.5	31.4	30.9	31.8
Inheritance tax	2.4	.05	0.7	1.8	2.1	1.6	2.4	2.4
Indirect taxes of which:	65.2	45.1	45.7	34.0	30.7	28.9	28.6	26.6
Liquor tax	17.6	18.5	13.8	7.9	6.3	5.0	5.4	5.0
Sugar tax	6.7	0.1	1.6	0.6	0.3	0.2	0.1	0.1
Gasoline tax	—	1.3	5.7	6.4	5.7	5.5	4.4	3.9
Commodity tax	—[c]	2.9	4.6	4.4	4.7	3.7	4.1	3.9
Securities transaction tax	—	0.0	0.6	0.2	0.5	0.7	1.2	1.2
Motor vehicle tonnage tax	—	—	—	—	1.5	1.4	1.3	1.1
Customs duty	12.8	0.3	6.1	4.9	2.6	2.3	1.8	1.7
Stamp revenue	6.8	1.6	2.8	2.8	3.3	3.0	3.7	3.5
Monopoly profits[d]	16.5	20.1	8.2	3.5	2.3	2.9	2.9	2.2
Total	100	100	100	100	100	100	100	100

Source: Ministry of Finance, *Monthly Statistics of Government Finance and* (Zaisei-Kinyu Tookei Geppo), No. 385, Special Issue on Taxation, May 1984, pp. 14-15.

Notes: a. As revised.
b. Initial estimates.
c. Textile consumption tax accounted for 3.4%.
d. From FY 1985, tobacco consumption tax.

9.1% in France, and 4.5% in Italy. The large share of the corporation tax in total tax revenue in Japan is mainly ascribed to the relative importance of the corporate activities in the national economy and to the postwar accelerated incorporation of individual proprietorships mainly for tax considerations.

Since its inception at the end of the last century, the corporation tax has undergone many changes in its nature and structure. In 1950, after the war, the corporation tax was completely reorganized in accordance with the recommendations of the Shoup Mission and then revised from time to time. Unlike the taxes of some European nations, in the absence of the imputation method with a "gross-up" factor of any extent, the Japanese corporation and income taxes achieve only a partial integration.

Corporations must compute their income once in each business year in a 12 months' period, which they may select. The computation is made in accordance with the generally accepted principles of business accounting. Capital gains are taxed in full and, furthermore, those from land owned for 10 years or less are subject to additional tax. On the other hand, various special measures are granted for capital gains on land. Dividends received from domestic corporations are, in principle, not included in the revenue. The useful life of fixed assets is legally prescribed and the methods of depreciation and inventory valuation are specified in rules and regulations. The laws and regulations incorporate all the methods utilized by standard accounting practice from which taxpayers are free to choose provided that a method once selected shall continue to be applied.

All expense accounts for social and entertainment expenses are tax deductible only within a certain limit. Contributions to the national and local governments, and the scientific, educational, cultural and welfare organizations designated by the Ministry of Finance may be deducted from taxable income. Other contributions and donations are deductible up to a certain amount. For policy purposes, various tax incentive measures, such as accelerated depreciation, investment tax credit or allowances and tax-free reserves are provided, mainly under the Special Taxation Measures Law. These concessions serve specific economic purposes but frequently at the cost of tax equity.

For two years beginning from 1 April 1984, the corporation tax rates have been raised from 42% to 43.3% on retained profits and from 32% to 33.3% on distributed profits. For corporations with capital of not more than 100 million yen, the tax rates on profits of up to 8 million yen have been raised from 30% to 31% if retained, and from 24% to 25% if distributed.

Closely held family corporations are subject to additional tax of 10, 15 or 20% on their retained earnings under certain conditions. This is designed to maintain tax equity between incorporated and unincorporated enterprises, which is a prime concern in Japanese tax policy and administration. Of the total corporations numbering over 1,541,000 in Japan, nearly 1,467,000 are subject to this tax on retained earnings of family companies.

Corporations must file returns within two months after the close of their accounting period. They also have to file interim returns and make prepayments of tax for the first six months of the period within 8 months after the beginning of the period.

5. Inheritance and gift taxes

Inheritance and gift taxes are both provided for in the Inheritance Tax Law. When first created in 1905, the inheritance tax was of an estate tax type. In 1950, it was changed to one of an accession tax type in response to recommendations of the Shoup Mission. In 1953, it was divided into an inheritance tax and a gift tax. The latter is to supplement the former as transfer tax. In 1958, an amendment was made to compute the inheritance tax on the basis of the value of the total estate and the number of heirs. Under the previous computation based on the value of the assets which each heir had received, how the assets were distributed among the heirs made a great difference in the tax burden. Under the present system, the over-all tax burden is equalized on the estate of the same value with the same number and types of theirs, regardless of the way it is distributed among the heirs.

The inheritance tax is imposed on the recipient of the assets from the decedent by inheritance, bequest or devise. If any heir or legatee has received property by gift from the decedent within 3 years before his death, the value of such property is added to the taxable assets. From the value of the property, 20 million yen is deducted as basic exemption as is 4 million yen each for statutory heirs in accordance with the shares as provided for in the Civil Code. A spouse receives one-third and the rest is equally divided among the descendants. The progressive tax rates ranging from 10% for an asset value of 2 million yen or less to 75% for over 500 million yen are applied to each share. The total tax on all the shares then is distributed among the heirs in proportion to the amounts which they actually receive. For the spouse of an inheritor or an heir under 20 years of age, the tax liability is reduced under the prescribed formulae. If an heir is neither a spouse nor a lineal descendant, his or her tax liability is increased by 20%. A tax return must be filed within 6 months from death.

The gift tax is imposed on the recipient of the asset by gift in a calendar year. As basic exemption, 600,000 yen is deductible from the taxable value. A lifetime allowance of up to 10 million yen may be deducted for residential property to a spouse who has been married for more than 20 years. The tax rates are highly progressive, ranging from 10% for the value of 500,000 yen or less to 75% for over 70 million yen. The gift tax previously paid on the property included in the estate is credited against the inheritance tax. A tax return must be filed between 1 February and 15 March of the following year.

The tax rates for the inheritance and gift taxes are not adjusted often but exemption levels have been raised frequently, taking into consideration the number of taxable inheritances. There has been no change in the exemptions since 1975 when they were substantially raised. Thus the decedents with estates of any taxable value as a percentage of the total decedents rose from 2.1% in 1975 to 5.3% in 1983.

6. Taxes on consumption

As shown in Table 2 and stated earlier, the revenues from indirect taxes accounted for about 65% of the total tax revenues before the war, but now only less than 30%. The indirect taxes are broadly classified into 6 categories as given in Table 4 and major items are described below.

(a) Liquor tax

The liquor tax is the single largest item, accounting for 18.6% of the total revenue from indirect taxes and 5.0% of the total revenues in the FY 1985 estimates. At the turn of the century, it contributed more than one-third of the total tax revenues. Before and soon after the war, the revenue from the liquor tax as a percentage of the total tax revenue was around 18%.

For taxation purposes, liquors are classified into 10 categories such as *sake,* wine and whisky and an ad valorem duty is applicable. The following are the illustrations of the effective tax rates on retail prices: *sake* 40.1% for the special class and 14.1% for the second class, beer 48.8%, wine 5.5%, whisky 50.3% for the special class and 28.3% for the second class.

(b) Commodity tax

Excise taxes are levied on particular commodities and services. The commodity tax in Japan was first created in 1940 on 57 items which were considered of a luxury nature or indicative of tax-bearing capacity. In wartime, with a view to securing government revenues as well as to curbing consumption, taxable items were nearly doubled. After the war, in accordance with the Shoup recommendations, daily necessities and business machinery were deleted from the list.The commodity tax has been revised from time to time to cope with economic changes. By the amendment of 1984, the items were increased from 80 to 85. In FY 1984, the revenue from the commodity tax accounted for 14.6% of the total indirect tax revenues. More than one-third of the commodity tax revenue is from passenger cars.

The taxable commodities are divided into two categories. Ten items coming under category 1 are levied at the retail stage at the rate of 15 or 10%. Under category 2, the commodities are levied at the time of shipment from factories or of receipt from bonded areas. The tax rates on automobiles range from 30 to

Table 3
Total tax revenue as percentage of gross domestic product

	Japan		*United States*		*United Kingdom*		*F.R. of Germany*		*France*		*Italy*	
	A	B	A	B	A	B	A	B	A	B	A	B
1965	17.8	14.4	26.5	22.2	30.8	26.1	31.6	23.1	35.0	23.0	27.3	17.9
1971	20.0	15.3	28.8	22.8	35.2	30.3	33.4	23.1	35.1	21.9	28.7	17.6
1975	21.0	14.9	30.2	22.8	36.0	29.7	36.0	23.7	37.4	22.2	29.0	15.7
1980	25.9	18.4	30.6	22.6	36.0	30.0	37.8	24.8	42.7	23.4	32.9	20.7
1981	26.9	18.8	31.2	23.0	37.4	31.3	37.3	24.1	43.0	24.6	33.7	21.6
1982	27.2	18.9	30.5	22.0	40.0	32.9	37.3	23.8	43.7	24.9	39.9	21.1
1983	—	—	—	—	38.3	31.3	37.2	23.9	44.1	24.8	—	—

Source: Same as Table 1, OECD op. cit., pp. 84, 85 and 191.
Remarks: 1. A.: Total tax revenue
B.:Total tax revenue excluding social security contributions.
2. Rounded at the second decimal place.
3. The figures for 1982 are provisional.

5% depending on their type and size. Since the government's monopoly of tobacco products is lifted as of 1 April 1985, the excise, ad valorem and specific combined, will be imposed on these commodities.

(c) Others

The travel tax is now mostly on trips by aircraft. Those who go to movies, sports events and horse races pay admission tax. The securities transaction tax is imposed partly in lieu of the tax on capital gains from stocks and bonds. Registration of real estate and licenses for banking and certain other businesses are subject to the registration and license tax. Stamp tax is levied on documents for transfer of assets and contracts. In the statistics the "stamp revenue" includes revenues from the stamp tax and registration and license tax which are paid in stamps.

Ranking second in importance as indirect tax, the revenue from gasoline tax accounts for 15.3% of the total indirect tax revenues in the FY 1984 estimates. This revenue is earmarked for construction and improvement of roads. The revenue from local roads tax, which is collected together with the gasoline tax, and a quarter of the revenue from the motor vehicle tonnage tax are earmarked for local roads. The revenue from the ad valorem petroleum tax is used for various programs to secure stable supply of petroleum and to develop alternative energy resources.

Today, customs duties in Japan are not principally for revenue purposes. They are primarily used for industrial policy. For this reason, customs duties are not discussed in this paper.

7. International aspects of the Japanese tax

For taxation purposes, individuals who have their residence or domicile, center of living in Japan for not less than one year are "residents" who bear unlimited tax liability and all others are "non-residents" who bear only limited tax liability. Nationality has rather little relevance. Corporate tax liability is determined, as in the United States, by the formal place of establishment (incorporation) rather than by the location of its effective management as in many European countries. Thus, corporations having a head or main office in Japan are subject to unlimited tax liability as "domestic corporations" and others are "foreign corporations" with only limited liability.

Unlimited taxpayers have to pay tax on all income regardless of its source, while limited taxpayers have only to pay tax on income from sources in Japan. However, resident individuals who neither intend to remain in Japan permanently nor continuously possess a domicile or residence for more than 5 years are classified as "non-permanent residents". Their income from foreign sources not paid within nor remitted to Japan is excluded from income taxation. This non-permanent residents status is devised to mitigate the financial strains which a foreigner may experience in the first years of his service in Japan.

The following are the major items of income to be treated as income from sources in Japan unless otherwise provided for in double taxation conventions: 1) income from business carried on in Japan or from an asset situated in Japan, 2) income from business of providing personal services performed in Japan, 3) rents on immovable property located in Japan, 4) interest on Japanese public or corporation bonds and debentures and on deposits in Japan, 5) dividends from domestic corporations, 6) interest on loans, 7) royalties for industrial properties in respect of business carried on in Japan or gains from the sale of such properties and 8) wages and severance pay for personal services rendered in Japan.

Non-residents or foreign corporations who have a fixed place of business such as an office, or permanent establishment such as a branch or factory, in Japan are subject to "aggregate income taxation" at the normal graduated tax rates on their income from sources within Japan. Those who undertake construction work for more than one year or carry on business through an agent in Japan are subject to "aggregate income taxation" on their income which is attributable to their business carried on in Japan. Other non-residents or foreign corporations are subject to withholding tax at 20% of gross revenue on their income from sources within Japan.

The taxable income and tax amount of non-residents and foreign corporations are in principle computed in the same way as for residents and domestic corporations. However, for non-residents, not all the deductions, exemptions and credits are allowed. For foreign corporations, some taxes such as the tax on undistributed profits and the special additional tax on family corporations are not levied. Some concessions are temporarily granted with respect to interest received by non-residents or foreign corporations.

Anyone who pays the items enumerated in (2) to (8) above as income from sources in Japan to a non-resident or foreign corporation is required to withhold income tax at 20%. If the payment is made abroad, e.g. through an overseas paying agent, the original payer who is a resident, domestic corporation, or non-resident or foreign corporation having a permanent establishment in Japan must withhold income tax in the same manner. If the recipient of the income items (2), (3) and (6) to (8) above has a permanent establishment in Japan, withholding of tax is not required under certain conditions.

A non-resident subject to "aggregate income taxation" or a foreign corporation, except one whose income is subject to only "separate income taxation", must file a return in the same way as a resident or domestic corporation. A taxpayer should pay tax by filing a return at the time of departure from Japan, or of termination of his business in Japan unless a tax agent is designated.

(a) Foreign tax credit

To eliminate international double taxation, foreign taxes levied on residents or domestic corporations are deducted from their income as necessary expenses or credited against the Japanese income or corporation tax. The overall limitation to the creditable amount is that portion of the foreign tax which the total income from sources outside Japan bears to the entire income subject to the Japanese tax.

For the sake of equal tax treatment of overseas operations through a foreign subsidiary and through a foreign branch, an indirect tax credit is granted to Japanese domestic corporations. With regard to the dividends which foreign subsidiary companies pay out of profits to their Japanese parent corporations, the foreign taxes imposed on such subsidiaries are credited against the Japanese taxes of their parent corporations if the following conditions are met: a) 25% or more of the shares or paid-in capital of the foreign subsidiary are owned by a domestic corporation, and b) such foreign taxes have been imposed on the subsidiaries concerned, provided they have been credited for the purpose of carrying on business in that foreign country and not for any tax considerations. The creditable amount is that portion of the foreign tax which bears the same ratio to total foreign tax as the amount of the dividends received by the domestic parent corporation bears to the total income of the foreign subsidiary minus foreign corporation tax imposed on that subsidiary.

In the light of the internationalization of the Japanese economy, taxation on the undistributed profits of foreign subsidiaries as a counter measure against tax havens was instituted in 1978. Under the Special Taxation Measures Law, as amended, if a domestic corporation owns 10% or more of the capital or shares of a foreign subsidiary in a tax haven, such portion of undistributed profits as is appropriate to the share is, in principle, included in the gross income of that domestic corporation. A foreign subsidiary in a tax haven means a foreign corporation whose head office is located in a tax haven and more than 50% of whose capital or shares is directly or indirectly owned by residents, non-residents especially connected with them, and domestic corporations. At present, 33 countries and territories have been designated as tax havens by the notification of the Ministry of Finance. In 1986, the law was amended further to close the loopholes in connection with tax havens.

(b) Double taxation conventions

By virtue of the Law of 1924, the Japanese Government has arrangements with several foreign countries to exempt shipping enterprises from taxes on a reciprocal basis. This law was replaced by the Law of 1962 which makes possible the mutual exemption of not only national taxes but also local taxes on income from air transport as well as shipping. However, a general tax treaty for avoidance of double taxation on income was only first concluded with the United States in 1954. At the same time, a treaty between the two countries on estates, inheritances and gifts was also signed. Since then, the network of double taxation agreements has been considerably expanded. Especially, conclusion of tax treaties has gathered momentum since the OECD adopted its Draft Convention for the Avoidance of Double Taxation with respect to taxes on Income and Capital in 1963 and its new version (hereinafter referred to as "OECD Model") in 1977. So far, Japan has entered into tax treaty relations with 35 capitalist and socialist states. In 1980, the Economic and Social Council of the United Nations (ECOSOC) approved the Model Double Taxation Convention between Developed and Developing Countries (hereinafter referred to as "UN Model"). The Japanese tax treaties are in principle based on the OECD Model with a slight deviation on some articles. The UN Model is also taken into consideration in its treaties with developing nations.

To determine the residence of a corporation, Japan uses the criterion of head or main office instead of effective management as adopted in the OECD Model. Under some of the Japanese conventions, the concept of permanent establishment is extended in certain respects. With regard to the enterprise profits, Japan's earlier conventions subscribed to the principle of taxing the entire income of a permanent establishment. Fol-

Table 4
Indirect taxes
(in billions of yen)

	1960		1975		1985ª	
	Amount	*Percentage*	*Amount*	*Percentage*	*Amount*	*Percentage*
Sumptuary taxes						
Liquor taxes	249	30.2	914	20.5	1,955	18.6
Tobacco consumption taxᶜ	147	17.9	341	7.6	882	8.4
Sugar tax	28	3.4	43	1.0	41	8.4
Subtotal	424	51.5	1,297	29.2	2,898	29.4
Taxes on specific goods and services						
Commodity	82	10.0	683	15.3	1,538	14.6
Admission tax	16	2.0	3	0.0	5	0.0
Playing card tax	0	0.0	1	0.0	1	0.0
Travel tax	4	0.5	35	0.8	77	0.7
Subtotal	103	12.5	7.21	16.2	1,621	15.4
Taxes on communication and acts						
Stamp revenue	51	6.1	480	10.8	1,366	12.9
Securities transaction tax	11	1.3	67	1.5	475	4.5
Bourse tax	1	0.0	10	0.2	17	0.2
Bank of Japan note issue tax	1	0.0	4	0.1	—	—
Subtotal	63	7.6	560	12.6	1,858	17.7
Earmarked taxes						
Gasoline tax	103	12.5	824	18.5	1,665	15.8
Local road tax	19	2.3	150	13.9	2.99	2.8
Liquefied petroleum gas	—	—	28	0.6	32	0.3
Motor vehicle tonnage	—	—	294	6.6	593	5.6
Aviation fuel tax	—	—	22	0.5	62	0.6
Promotion of power-resources development	—	—	30	0.7	224	2.1
Petroleum tax	—	—	—	—	454	4.3
Subtotal	122	14.8	1,347	30.3	3,329	31.7
Others						
Customs duty, and customs duty on oil	110	13.3	508	11.4	813	7.7
Tonnage duty, and special tonnage duty	2	0.2	15	0.3	20	0.2
Subtotal	112	13.6	523	11.8	832	7.9
Total	823	100.0	4,449	100.0	10,519	100.0
Total national tax revenues	1,802	45.7ᵇ	14,507	30.7ᵇ	39,494	26.6ᵇ

Source: Calculated from Ministry of Finance, *Monthly Statistics of Government Finance and Banking* (Zaisei-Kinyu Tookei Geppo), No. 397, Special Issue on Taxation, May 1985, pp. 80-81.

Notes: Details do not add to the totals because of rounding.

a. Initial estimates.

b. Revenues from indirect taxes and percentage of the total tax revenues.

c. Until FY 1984, monpoly profits.

lowing the OECD Model, however, they have turned to the principle of taxing only the income attributable to such permanent establishment. The allocation of profits to a permanent establishment is to be based on the "arm's length" rule. In this connection, Japan is also faced with the problems of transfer pricing among associated or multinational enterprises. Under some treaties with developing countries, taxation of profits from international transportation, especially of shipping, is shared by both contracting parties.

Passive income is, in principle, taxable in the source country at the following maximum rates: 10%, as against 5% in the OECD Model, on the dividends, 10% on interest, and 10% on royalties, which, however, are exempt from tax in the source country under the OECD Model. The right to tax income and capital gains from immovable property is given to the country where such property is located.

The rule of taxation on income from personal services is to tax such income in the country where the services are performed. As a matter of principle, income from independent personal services is not taxable in the country of source unless the person has a fixed base there. Salaries and wages of employees are not taxable in the source country if their presence there does not exceed 183 days. Fees of a member of the board of directors are taxable in the resident country of his company. Income of entertainers and athletes may be taxed in the country where their activities are rendered regardless of the period of their stay there. Pensions paid in consideration of past employment are taxable only in the resident country of a recipient. Remuneration of a government employee; who is not a national of the country where he performs his service is exempt from tax in that country. Students and business apprentices are exempt from tax of the host country on the income which they receive from abroad. All the Japanese treaties, with one recent exception, exempt teachers and professors from taxation in the host country for a period, in principle, not exceeding 2 years, although neither the OECD nor the UN Model has such a provision.

Of the two methods for elimination of international double taxation as provided for in both Models, Japan always employs, in its conventions, the credit method whereas most other parties apply the credit method to investment income and the exemption method to other kinds of income. Most Japanese treaties with developing countries are noted for the tax sparing credit for the purpose of helping these nations to achieve the objectives of their tax incentive measures for economic development. Under this device, the Japanese investors may deduct from their own tax in Japan an amount corresponding to the tax which would have been paid to these countries but for such tax concessions. Japan grants this tax sparing credit not only for the foreign taxes spared by domestic legislation of these countries but also for those which would have been fully imposed if it were not for exemption or reduction of tax rates in the source country on income from investments by virtue of the tax conventions.

8. Tax administration

(a) Organization of the tax administration

While the Tax Bureau of the Ministry of Finance is responsible for Japan's tax policy, the National Tax Administration (NTA) is in charge of tax administration. The Tax Bureau prepares tax bills mainly on the basis of the recommendation of the Tax Commission. The Commission, consisting of economists, lawyers and leading figures in various fields, studies and recommends on the long-range tax policy as well as year-to-year changes in the tax system.

Under the National Office of the NTA, an affiliated agency of the Finance Ministry, there are 11 Regional Taxation Bureaus, Okinawa Regional Taxation Office and 511 Taxation Offices.

As the only supervisory agency, the National Office itself does not audit taxpayers. The Regional Taxation Bureaus oversee Taxation Offices as well as directly audit large corporations and handle cases involving tax fraud, evasion or arrearage. The Taxation Offices are empowered to assess and collect every kind of internal tax. Of the total number of 52,825 tax officials as of July 1983, almost 80% are assigned to the Taxation Offices. More than half of the tax officials are engaged in direct tax work. In the last decade, the number of tax officials has been levelling off while individual taxpayers filing a return and corporations increased in number by some 40% and 50%, respectively, from 1972 to 1982. The cost for raising every 100 yen of national tax was more than halved from 2.79 yen in FY 1950 to 1.28 yen in FY 1983.

To protest on alleged infringement of his legal rights by the actions of the tax authorities with regard to the national tax, the taxpayer must first lodge an administrative protest. The case may not be brought to the court until a decision is made on such protest by the administration. Such administrative protest is to be filed with the agency which has made the original disposition, usually the Director of the Taxation Office. This is termed as "the request for reinvestigation". If the taxpayer is not satisfied with the decision resulting from such reinvestigation made by the administration, he can file a request for reconsideration generally with the National Tax Tribunal. The Tribunal was established in 1970 for the purpose of adequately protecting the rights of taxpayers. As an organ attached to the NTA, it has 12 Regional National Tax Tribunals and 8 Branch Offices. The President is appointed by the Commission of the NTA with the approval of the Finance Minister. The judges are appointed from among experienced judges of civil courts, tax officials or high ranking officials in the civil service.

(b) Implementation of the direct tax regime

Under the self-assessment system, each taxpayer computes the tax base and tax amount and files a return with the Taxation Office. The Office examines the returns and if found incorrect, such returns are subject to reassessment or correction by the Director of the Taxation Office. In 1982, nearly 2.9 million income taxpayers carrying on business other than agriculture were eligible for filing a blue return, and of these, more than 1.4 million actually did so. More than 1.7 million corporations filed a blue return, accounting for 91.1% of the total corporations. In filing a return, those taxpayers who are not eligible for the blue return (white return taxpayers) may ask for necessary guidance at the consulting booth provided by municipalities or Tax Accountant Associations as well as the Taxation Offices. The number of those who were reassessed by the Taxation Offices in 1981 as a result of checking returns and audits was about 26,000 or 0.4% of the total taxpayers, and the amount of tax increased by such reassessment was 5.9 billion yen, or 0.2% of the total revenues of the self-assessed income tax.

The tax withholding system plays a vital role in the self-assessment regime. It has many advantages, such as enhancing tax compliance, ensuring tax revenue, serving taxpayers' convenience, and improving efficiency in tax administration. During FY 1982, 72% of tax withheld was from employment income. Owing to the unique mechanism of the year-end adjustment by the withholding agents, of 33.8 million wage and salary earners in total, only 3.6 million were required to file a return.

The corporations which filed a return as a percentage of the total corporations liable to file a return remarkably increased from 59% in FY 1950 to 92% in FY 1982. Audits concerning the corporation tax are classified in principle according to the amount of corporation's capital. Corporations with capital of more than 100 million yen as well as all foreign corporations come within the jurisdiction of the Regional Taxation Bureaus and the other corporations are under that of the Taxation Offices. The former corporations totalled only 19,000 in number but the amount of the tax paid by these corporations accounted for 63.2% of the total corporation tax revenues in FY 1982. Field audits were conducted on 195,800 cases at the Taxation Office level during FY 1982, which represented 10.7% of total corporations, taking on the average 5.6 days per corporation. Inquiries into banks were made in relation to 16% of the field audit cases. For 80.6% of the field audit cases a correction or determination was made and for 25.5% of these cases willful false reportings were found. Back in FY 1950, of the total corporation tax collections, 68.9% was paid by self-assessment and the rest was the net increase by correction or determination by the tax authorities. In contrast, in FY 1982 as much as 96.1% was voluntarily paid by self-assessment.

INDIA:

Taxes on capital

by Parimal M. Parikh

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WEALTH-TAX

In India, the wealth-tax was introduced on the basis of proposals by Prof. Nicholas Kaldor in a study he conducted for the Government of India. His argument in favour of the wealth-tax was that income-tax had the defect of penalising risk bearing. A person owning wealth paid a lower tax if his wealth was invested in low income-yielding assets such as Government Securities, but a much higher tax if it was invested in a highly productive form, such as high-dividend-yielding securities. Prof. Kaldor recommended an integrated direct tax system. He advocated the reduction of income-tax and, to make up for the loss, he suggested introduction of a wealth-tax, so that hoarders of wealth would be encouraged to switch over from unproductive to productive assets. According to Prof. Kaldor, an annual tax on capital was really a tax on affluence. To quote him

> the present system of direct taxation in India is both ineffective and inequitable. It is inequitable because the present base of taxation "income", as statutorily defined, is defective and biased as a measure of taxable capacity and is capable of being manipulated by certain classes of taxpayers. It is inefficient because the limited character of information furnished by taxpayers and the absence of any comprehensive reporting system on property transactions and property income make a large-scale evasion through concealment or understatement of profits and property income relatively easy.

Again,

> equity in taxation between income from work and income from property cannot be secured unless (i) the concept of income is made sufficiently comprehensive to embrace all beneficial receipts which increase the taxpayer's spending power, and not merely the conventional form of income, (ii) the tax on income is supplemented by an annual tax on capital wealth in recognition of the fact that taxable capacity cannot be adequately measured either by income alone or by capital wealth alone, but can be approximated through a mixture of both.

As such, with a view to reducing the possibilities of tax evasion and ensuring a more effective and more equitable basis for taxation, the Wealth-tax Bill was introduced in the Parliament for the first time on 15 May 1957 and received the assent of the President on 12 September 1957. However, it was deemed to have come into force from 1 April 1957. The Finance Minister, in his budget speech, emphasised that income was not a sufficient measure of tax paying capacity and that the system of taxation on income had to be supplemented by taxation based on wealth. It was found necessary to adopt measures which were egalitarian in intent but did not have a disincentive effect.

The legislative competence of Parliament to a levy a wealth-tax was challenged. However, it was set at rest when the Supreme Court, in the case of Sudhir Chandra Nawn (69 TR 897), decided in favour of the State by holding that there was no constitutional prohibition against Parliament levying tax in respect of the same subject matter or taxing event in successive assessment periods.

ESTATE DUTY

A Bill to provide for the levy and collection of estate duty was introduced in the House of People on 11 August 1952. The object of the Bill was to impose an estate duty on property passing or deemed to pass on the death of a person. The levy and collection of income-tax at high rates since the second world war and the investigations undertaken by the Income-tax Investigation Commission in a number of cases of tax evasion had, no doubt, to some extent prevented the further concentration of wealth in the hands of those who were already wealthy. However, with a view to introducing positive steps in reducing the inequalities in the distribution of wealth, estate duty was imposed to rectify such unequal distributions to a large extent. It was also thought to assist the States towards financing their development schemes. In its draft outline Report, the Planning Commission had also stressed the necessity to levy death duties in India as soon as possible.

A Bill seeking to impose such a duty was first introduced in 1946 and then re-introduced in the provisional Parliament in 1948. The latter Bill, after being considered by the Select Committee, lapsed on the dissolution of that Parliament. The Bill introduced on 11 August 1952 was practically a reproduction of that Bill as reported on by the Select Committee, but certain changes were made, as follows:

1. When the earlier Bill was drafted, the Centre[1] had no jurisdiction to legislate in respect of agricultural land, but since then some States had passed the necessary resolutions under Article 252 of the Constitution, and this Bill therefore applied also to agricultural land in such States.
2. In respect of the movable property of the deceased, the levy of duty was to depend upon his domicile only. The alternative basis of residence in the Bill as amended by the Select Committee was omitted.
3. As in the case of the income-tax law, the fixation of the rates of duty and the maximum limits of exemption was to be regulated by the annual Finance Acts.
4. Under Article 269 of the constitution, the net proceeds of the estate duty were to be assigned to the States on such principles of distribution as Parliament may formulate. The appropriate estate duty on agricultural land situated in a State would, however, be assigned to the State.

ABOLITION OF ESTATE DUTY

The Finance Bill 1985 which was introduced in the Indian Parliament on 16 March 1985 seeks to abolish the levy of estate duty in respect of estate passing on death occurring on or after 16 March 1985. The Finance Minister in his budget speech indicated that as both wealth-tax and estate duty laws apply to the property of a person, the former applying to his property before death and the latter after his death, the existence of two separate laws with reference to the same property amounted to procedural harassment to the taxpayers and the heirs of the deceased who have to comply with the provisions of two different laws. After considering the relative merits of the two taxes, he was of the view that the estate duty has not achieved the twin objectives for which it was introduced, namely, to reduce unequal distribution of wealth and to assist the States in financing their development schemes. While the yield from estate duty was only about Rupees 20 crores (1 crore = 10 million) its cost of administration is relatively high. He, therefore, proposed to abolish the levy of estate duty in respect of estates passing on deaths occurring on or after 16 March 1985.

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[1] Editor's note: the Central State as opposed to the individual Indian States.

United Kingdom: The search for fiscal neutrality in the tax treatment of savings

By Dick Taverne

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One of the much criticised features of the British tax system is its treatment of savings. Contributions to approved pension schemes are exempt from income tax; so is the interest paid on mortgages, up to a total limit of £30,000 borrowed; so is money invested in the Business Expansion Scheme, that is money invested in a small business up to a limit of £40,000, provided that the business is not one's own or one's family's or one in which the investor is a director. In addition pension funds receive privileged tax treatment on the income of their investments and despite the fact that the contributions to pension schemes have themselves been exempt from tax, pensioners may also receive part of their pension in the form of a tax-free lump sum.

By contrast, investors who put their money into building societies or bank deposit accounts have income tax deducted from the interest paid out and cannot reclaim the tax deducted even if their income is below the tax threshold. The investments themselves are not deductible. Nor are normal investments in stocks and shares.

The explanation for the fiscally privileged treatment of some savings and the discrimination against others is largely historical and accidental, rather than founded on reason. It has been argued that whatever the history, the tax advantages make sense because we should encourage people to own their own houses and to provide for their retirement. In addition, the encouragement of small businesses is an obviously desirable economic aim. Nevertheless, whatever the advantages they are more than outweighed by the distortions the fiscal privileges have created both in the savings market and in the tax system as a whole.

The attack on fiscal privileges takes two main forms. The first is that the exemptions mean much higher tax rates than would have to be imposed if the exemptions did not exist. They therefore act as a disincentive to effort. This theme has been strongly taken up in the past by Conservative tax reformers. The cost of the exemptions to the Revenue is indeed so large that a study published by the Institute for Fiscal Studies in the mid 1970's estimated that the abolition of the main exemptions could lead to a cut in the basic rate of tax paid by the vast majority of British taxpayers of a third. To reduce tax rates from 30% to 20% is obviously a prize worth aiming at. Indeed the Conservative government, which was determined to cut taxes and tax rates on assuming office, saw two ways of achieving their aims: lower public spending and broadening the tax base by eliminating exemptions. Neither has proved an easy road to their goal.

The second criticism is that fiscally privileged treatment of some favoured categories of savings distorts the pattern of savings generally with effects which are either socially just or economically beneficial. The injustice stems from the fact that the exemptions tend to favour the wealthy saver and discriminate against the small saver. The Business Expansion Scheme for instance has proved a major tax haven for high earners. Indeed its exploitation as a means of tax avoidance has been so extensive that the Chancellor of the Exchequer had to limit its scope in the last Budget, by excluding various property-based schemes which had attracted the bulk of the B.E.S. savings. Even after the Budget most of the schemes advertised are more concerned with the opening of new restaurants, promoting wine importers and a variety of luxury service trades, than seeking risk capital for new technological ventures. The contrast could not be more stark between the tax avoidance opportunities for high earners and the disadvantageous tax treatment of small savers putting their money in building societies and deposit accounts.

The economic disadvantages are less immediately apparent and perhaps more arguable. They lie in the fact that the tax system channels savings overwhelmingly into institutional hands and into forms of investment which are essentially unadventurous. Comparison with other industrial countries certainly shows that a far higher proportion of wealth in Britain is tied up in forms of saving that are difficult to realise, namely houses and pensions. Shares on the Stock Exchange are overwhelmingly held by the institutions, the life assurance companies and the pension funds, while the personal investor's proportion of shareholding steadily declines. But by their nature the institutions are cautious in their approach to investment. They have to be because their first duty is to their policy holders. They do not and should not take risks. New businesses on the other hand are typically started by former employees of large corporations who decide to take a chance and invest their own savings in their own business. They cannot do so if their savings are mainly tied up in their house or their pension, as is true of most British executives. It is almost bound to be so when buying a house and contributing to pension schemes is so much more tax advantageous than keeping money in more accessible forms of savings like a bank account or shares. That is why tax privileged institutional savings have expanded and personal, more mobile and accessible savings have steadily declined.

As for the argument that house ownership and savings for retirement should be encouraged, these are certainly worthwhile aims. So much so that most people would pursue them anyway. Most people do prefer to own their own house and do realise the need to provide for their retirement. But the decision to own rather than rent, or to make pension contributions rather than to invest in shares or a more risky form of savings, should be taken on its own merits, not forced on people, as it were, by the tax system. Indeed a combination of the tax system and various laws giving elaborate protection to tenants has dried up the supply of private rented accommodation in Britain, greatly to the disadvantage of the mobility of labour which the British economy badly needs.

The case, therefore, for neutrality in the tax treatment of savings in Britain is a strong one. Not only Conservatives hoped when Mrs. Thatcher came to power that their declared aim of broadening the tax base and ending the main exemptions would be vigorously pursued.

In fact very little has happened. Mrs. Thatcher declared early on that mortgage relief would stay. The only change the government has made is that the upper limit of the sum borrowed on which relief is allowed has been raised from £ 25,000 to £ 30,000. The government did end the partial relief for premiums paid under life assurance policies, whereby 15% of the premiums could be offset against the basic rate of income tax. Last year the Chancellor of the Exchequer also hinted that he was proposing to tackle the privileged position of the pension funds, either by disallowing the deduction against tax of contributions, or by ending the exemptions granted to the investment income of the pension funds, or by taxing the lump sums payable under various schemes, which are now exempt despite the fact that the contributions which created the sums were also exempt. Again, however, nothing was done. Indeed while one modest step was taken towards the principle of fiscal neutrality, namely the abolition of life assurance relief, a major step was taken in the opposite direction by the creation of the Business Expansion Scheme, which, as mentioned, has proved to be one of the most advantageous of all tax havens to the wealthy investor.

What is the explanation for this disappointing climbdown? It is that the Chancellor stepped onto the right road but then proceeded to travel in the wrong direction. To put it in another way, he found himself swimming against a political tide, which always flows strongly in favour of exempting savings from tax and which overwhelms anyone who tries to eliminate exemptions on which so many people have come to rely. The right direction towards fiscal neutrality is not to abolish particular exemptions for particular forms of savings, but to extend them to all savings, but to extend them to all savings and then to tax dissavings as part of income.

The majority of people in Britain now own their own house and the majority of home owners are paying interest on their mortgage on which they receive tax relief at the rate of 30%. If the tax relief were abolished, they would find their interest payments increase by over 40% (30% on top of the 70% of the gross sum now being paid). Many of them have bought a house even when they can barely afford the interest because rented accommodation is not available and also because the tax advantages of acquiring a house are so great. As their resources are often stretched to the limit, a rise in mortgage rates, say from 12% to 14% as happened earlier this year, imposes a heavy burden (and is politically very unpopular). A drop in mortgage rates is always regarded as a great boost to the government in power and a rise in rates the opposite. An increase in mortgage rates of as much as 40% would not only be ruinous for millions of people, but would be disastrous for any government.

In addition the existence of the relief has raised house prices. Its abolition would lower prices and help new buyers. But those who had bought their house at the higher old price would not only be faced by a ruinous rise in interest payments, but would suffer a sharp drop in the value of what is more often than not their most valuable asset. It is therefore not surprising that politicians shy away from any suggestion that mortgage tax relief should be abolished, however gradually it might be phased out.

Similar difficulties faced the Chancellor when it came to tampering with the tax reliefs for pensions. To abolish the relief on contributions would mean a sizeable increase in the tax bills of the 11 million people who are members of the private pension schemes. Alternatively, if the contributions were scaled down to leave net earnings unaffected, there would be a corresponding decrease in the pensions people could expect on their retirement. Full taxation of the investment income of pension funds would be bound to lead to a reduction in the pensions payable and could hardly therefore be retrospectively introduced. To apply it only in the future would lead to a very long time lag before additional revenue was received by the Exchequer. Even the wholly illogical and indefensible tax free lump sum payable on retirement is a vested right. Many people have made their retirement plans on the basis that it would be paid. These expectations cannot suddenly be shattered. Many pension schemes can of course be remodelled to substitute a higher pension and no lump sum, but it would require a renegotiation of all public service pensions in which at present no option is provided to choose a higher pension in place of a lump sum.

The fact that the Chancellor was swimming against the tide in his search for fiscal neutrality is confirmed by the history of the exemptions he would like to abolish and indeed by his own recent measures. The exemptions are there because politicians created them for apparently worthwhile causes for which strong pressures existed. The Chancellor himself gave way to the same pressures when the Business Expansion Scheme was set up. Encouraging new businesses seemed such a worthwhile aim and so important to the economy that a new form of privileged savings was established. In fact, like other well-intentioned forms of tax incentive, it has had unexpected side effects, mainly wide opportunities for tax avoidance. This meant that it had to be limited in scope to an extent that has partially defeated its original aim. The most important element in the start up of new businesses, namely investment in one's own business, had to be excluded from the relief.

Does this mean that the search for tax neutrality is a hopeless quest? Fortunately not. The alternative route is still open, namely to abolish tax privileges by extending them to all savings and recovering the revenue thereby lost by bringing the disposal of savings into the income tax base. This was the route advocated by the Meade Committee's report on The Structure and Reform of Direct Taxation in Britain published in 1977, by the Lodin Commission in Sweden and later elaborated, inter alios, by Kay and King in their book *The British Tax System,* by Prof. Bradford in the U.S. and most recently by Alice Rivlin and her colleagues in the Brookings Institution. Proposals on these lines have also recently been put forward by the Social Democratic Party in Britain. This line of approach has been variously called a Personal Expenditure Tax, a Consumption Tax, a Cash Flow Income Tax and Lifetime Expenditure Tax. Whatever the name, the principles are in each case similar.

A person is taxed on his income plus his dissavings less his savings. This means that he is in effect taxed on his expenditure, but without having to account for each item spent. The tax should of course be distinguished from V.A.T. or other forms of indirect taxes on spending. It is a form of direct, not indirect, taxation and in most models is a progressive tax, with higher rates for higher spending. Three examples can best illustrate the broad principles of the tax:

1. Someone earns £ 20,000. He sells £ 10,000 worth of shares (or sells a house whose sale price exceeds the outstanding mortgage by £ 10,000) and reinvests £ 5000. He pays tax on £ 25,000, i.e. £ 20,000 plus £ 10,000 minus £ 5000.
2. Someone earns £ 20,000. He sells £ 10,000 of shares and reinvests £ 5000 in other shares and £ 5000 in a premium for an annuity. He pays tax on £ 20,000 because he has made neither a net disinvestment nor a net saving.
3. Someone earns £ 20,000. He sells no shares or any other capital assets, but manages to put £ 3000 into his own business and another £ 2000 into a pension scheme. He pays tax on £ 15,000. This probably means that he also pays tax at a lower rate if the tax is charged on a progressive scale.

The principle of the tax is therefore simple. But the question will immediately be asked: if the tax gives relief to all savings, rather than to certain special categories of savings, how are savings defined? There is of course no universal objective answer. Different advocates will give different definitions. The Social Democratic Party in Britain in its recent proposals, which were largely based on those in Kay and King on The British Tax System and on earlier ideas set out in the Meade Report, suggested a schedule of registered assets whose purchase should qualify as a tax deduction and whose sale would have to be declared as part of one's tax base. There would be political argument about what should feature in the schedule, but presumably there would be broad agreement that it should include what most people now accept as being savings. This would include investment in property, land, stocks and shares, life assurance policies and pensions. It would not include personal motor cars, yachts, furniture, jewellery and of course living expenses. Deposit accounts and building society accounts would be in; current accounts would be more doubtful; I feel sure that works of art would have to be excluded, partly at least because they would be too difficult to define.

How important will it be whether an item is included in the schedule, so that it attracts tax relief when purchased, or is excluded and classified as expenditure? Not necessarily of crucial importance. It depends whether there is an effective tax on inheritance or alternatively on whether legacies and gifts are regarded as a form of expenditure.

First, while there is an obvious advantage in having an item classified as a registered asset because tax is deducted on its purchase, there is a corresponding disadvantage in that it will become part of one's tax base if sold. If, for example, deposit accounts were registered assets and current accounts were not, it might in certain circumstances pay one to end up the year with more money in a current account than in a deposit account. This would be in order to even out one's tax bill between years of high and low expenditure. In a year of relatively low spending money could be placed in the current account, thus increasing one's tax bill. Then in the following year of high spending one could draw the money out without it being added to one's tax base.

The relevance of inheritance taxes (or treating legacies and gifts as a form of expenditure) is that without them investment in registered assets which were never realised would provide the opportunity for great accumulations of untaxed wealth. If inheritance is taxed, the problem of accumulation, which has worried some egalitarian opponents of the expenditure tax, can be overcome.

Let me now turn to the advantages of the reform. First, it would achieve the much sought after neutrality in the tax treatment of savings. It would tend to encourage enterprise. No doubt, as already mentioned, most people would continue to seek security first, by buying their own home and providing for their pension. But more people would now find it economically more attractive to invest in their own business, or their family's business, or a business in which they had a role in management, all investments which are now excluded from the Business Expansion Scheme. Generally speaking, there would be somewhat more personal investment, which tends to be more adventurous, and relatively less institutional investment, which tends to be more cautious.

Next it would promote greater fairness as between savers. The small saver, saving through his building society account or putting his money into a deposit account, would no longer be discriminated against. The advantage of being able to afford the most expensive advice for tax planning would be somewhat less important.

This is partly due to the next important advantage: the tax system would become simpler. Part of the complexity of the present system is due to the elusive indefinable nature of the concept of income as compared with the concept of expenditure. What is income? The question has been asked by judges and by theoretical economists and no clear or satisfactory answer has ever emerged. The issue is not an academic one because it affects the distinction tax laws now have to draw between increased spending power which derives from earnings and that derived from a capital transaction. Under most tax systems the former is taxed at a higher rate than the latter, yet the distinction between the two is often obscure and provides almost limitless opportunities for tax avoidance. If I buy and convert a house, which is not my residence, and sell it at a profit, the profit on the transaction may sometimes be regarded as a capital profit from the realisation of an investment and at other times as a venture in the nature of trade subject to income tax.

Under the expenditure tax Capital Gains Tax can be abolished. This is because the Inland Revenue will no longer be concerned with the question whether a gain or a loss has been made on the sale of a registered asset, but only with the question whether the proceeds of the sale have been spent, in which case they would be added to one's earnings and taxed, or reinvested, in which case they would be exempt from tax. As a result the tax form individuals have to submit can be greatly simplified. At the moment one has to keep elaborate records of the history of each capital asset acquired, so that on its final sale the Revenue can know whether there has been a gain or a loss. Under the new tax one would only have to supply details of net disposals or net purchases. There would therefore not only be a simpler tax form, but at a stroke one of the major sources of tax avoidance and confusion, which has plagued the tax administrations of many countries, the distinction between capital gains and gains in the nature of income, would have been eliminated.

Would tax rates have to be raised, since exemption would now be given to savings previously not deductible from tax? It is almost impossible to give a firm answer to the question. Certainly there would not be a broadening of the tax base to the extent which the Conservatives originally hoped. But it seems most unlikely that revenue would be diminished. Exemptions in Britain have eroded the tax base to such an extent that the revenue gained from making the proceeds from the realisation of all savings taxable is likely to be at least as great as the loss of revenue from allowing previously non-exempt savings to be deducted from tax. The best guess one can make in the absence of figures which are not at present available is that the change would be broadly revenue neutral.

A number of other questions arise: Would the reform be politically acceptable? Would it increase unemployment, since it might be expected to increase savings and reduce consumption, when more consumption is needed to stimulate employment? How would it relate to corporate taxation? What would be the international implications? And finally, how would the tax be introduced?

Obviously one cannot tell in advance how such a reform would be received. All major tax reforms are in a way bound to be unpopular because they will give rise to fears and misconceptions. Moreover those who will lose under the changes will protest loudly, while those who stand to gain are likely to be sceptical until the benefits have actually materialised. The gainers under this reform will be earners who save. The losers will be the owners of capital who spend more than they earn. Some egalitarians will protest that the accumulation of wealth becomes too easy, but this can be balanced by strengthening inheritance taxes or treating legacies and gifts as realisations – in which case there will no doubt be an outcry that taxes on death are too severe. But by and large it seems likely that a tax which favours earners and treats savers evenhandedly will be acceptable; so will a tax that gives people rather more control over the evening out of their tax burdens between years of uneven expenditure. The abolition of the unjustifiable exemption from tax of the lump sum payable under present pension schemes is again more acceptable if such part of the sum as is reinvested is exempt from tax. The simplification of the system should be welcome. The greatest outcry, however, would arise if inadequate provision is made for the transition period – if, for example, people who had saved out of their taxed income during their working lives found that when they came to realise their savings during retirement these savings were taxed for a second time. But more about the transition later.

The impact of the tax on total savings is unpredictable. On the face of it there would be more savings because more savings would now attract tax relief. But experience has shown that savings behaviour is not always economically rational. At times of high inflation savings become disadvantageous, but often increase because people fear for the future. At times of deflation when it would pay to save, savings often decline because people have to spend out of capital. What is likely to happen is that the kind of savings people select is likely to change, with a somewhat higher proportion going into forms which were previously at a tax disadvantage, such as highly mobile, accessible personal savings. If there was an impact on the total level and the government felt that for conjunctural reasons savings or consumption should be increased or discouraged, the tax will provide them with an efficient instrument for achieving their aims, because raising or lowering tax rates will have a much greater impact on levels of spending than raising or lowering present income tax rates.

The relation between an expenditure tax and corporate taxation is a separate subject. Corporation tax in Britain could casily be transformed into a cash flow corporation tax as a mirror of the personal expenditure tax. The tax would be chargeable on the money paid out by a corporation to individuals, whether by way of dividends or capital. The major problem which might arise is more part of the next question, namely the international implications. Harmonisation of corporation taxes within the EEC might become more difficult. Since however there are no signs of any progress towards such harmonisation, the problem is hardly an immediate one.

Other international complications might be more immediate. Suppose Britain had an expenditure tax and other countries (except perhaps Sweden) continued to tax income on the present basis. There might be an overwhelming temptation for Britons to emigrate on retirement, since the tax avoider's dream might be to earn one's money in a country which taxed spending and to retire to spend it in a country which taxed earnings. This led the Meade Committee (before the abolition of Exchange Controls) to toy with the idea of treating the export of capital as a form of expenditure. It seemed at the time as a somewhat Draconian solution, which would be even more unacceptable if Exchange Controls continued in abeyance.

Personally I believe that one can be relaxed about the fear of a massive emigration of rich pensioners. There are already strong tax incentives for emigration to tax havens like Malta or the Cayman Islands. Not many people are tempted to use them. The number of people who allow tax considerations to dominate their lives is fortunately limited. The desire to pay less tax is universal, but so is the desire to stay with one's own friends, near one's children and generally in an environment which is familiar and friendly. Most people are too sensible to expect the life of a tax exile to be an El Dorado. Quite apart from this, it might not have a bad effect on an economy if the tax system made it a good place to work in, even if it was then more tax advantageous to retire elsewhere after one's working life.

There is little doubt that the biggest problem in the way of the reform is the transition. As already mentioned, it would be wholly unacceptable to introduce the system overnight in a way that led to the taxing of the proceeds of sale of an asset which was purchased out of taxed income. There would also be the danger of massive tax evasion if there was a sudden introduction. Suppose for example, as seems likely, that jewellery and antiques were not listed as registered assets that qualified for tax deduction. Their realisation would not therefore be included in the tax base. Investments which had been exempt from tax when made could be turned into jewellery or antiques on the day before the tax took effect. When sold after the changeover they could then be gradually turned into registered assets with a major reduction of tax liability.

The problem of transition has not yet received the attention which it needs. But a number of suggestions have been made which would have to be examined jointly with the Inland Revenue if the prospect of the reform comes closer. One is a gradual introduction whereby, say, £ 1000 of registered assets become deductible in year One (and declarable as income if thereafter sold); £ 5000 in year Two; £ 10,000 in year Three – or whatever sums were deemed appropriate – and so on. A similar suggestion is that one tenth of registered assets bought and sold in the first year should become deductible and taxable; two tenths in the second year; and so on.

It is also possible that the reform may be introduced gradually by the back door as it were, through the reform of private pensions. There has been much concern in Britain about the unfair effects of present pension schemes on employees who change their employer. Under most occupational schemes they are only entitled to rights which have been acquired up to the end of their employment and generally lose the benefits which would flow from an increase in their salary over the years if they had stayed. Integration of their former rights into the scheme of a new employer is normally impossible and they have to start a new scheme. Changing employment can leave them much worse off in retirement. It is also felt that industry in Britain might benefit from a greater mobility and readiness to move of executives.

The suggestion has recently been made that companies should offer their employees the choice of a portable pension, over which the employee would have full control, to invest the premiums paid in any way they wish, while still receiving tax relief. So they would be free to invest their own pension fund in stocks and shares, leave it to be managed by a professional fund, put it into the purchase of a house or into their own business.

The government has not accepted the suggestion in full. It has moved some way towards making pensions more mobile, provided the investment is managed by a professional fund. Individual employees will now be able to opt for the kind of scheme which is now available for the self-employed. But if the suggestion were taken further, as many pension reformers would like to see, it is clear that a major step would have been taken towards the expenditure tax.

To sum up, the aim of fiscal neutrality in the treatment of savings is widely accepted as a desirable aim. The government's preferred route to this goal has now been shown to be politically unacceptable. It is unlikely that the Conservative government will revive its original plans for the elimination of all tax exemptions. Indeed in their desire to encourage investment in small businesses they have found themselves extending the exemption to other special forms of savings. There remains the route of the personal expenditure tax. So far the reform has been proposed only by one party, the SDP (although it seems that their allies the Liberals also look on the tax with favour). The SDP and Liberals are however still some way from achieving power and having the chance of putting their plans into effect. But it is noteworthy how the idea of an expenditure tax has spread since it was first powerfully raised by the Meade Committee in 1977. At the same time other developments like the concern about the transferability of pensions promote the idea by stealth rather than by the frontal assault of inclusion in political programmes. It seems much more likely now than when the Meade Committee reported that the tax will eventually be introduced.

CANADA:

1985-86 Federal Budget; Business Purpose and Advance Rulings; Treaty Developments

by Allan R. Lanthier

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1985-86 FEDERAL BUDGET

On 23 May 1985, the Minister of Finance, the Honourable Michael H. Wilson, delivered the Canadian Federal Budget proposals for 1985-86 and the first Budget of the Conservative government since coming to power 8 months earlier.

Mr. Wilson was faced with a delicate balancing act between the two major economic problems facing Canada – persistent and continuing high unemployment and the federal government deficit. Despite real growth of 4.7% in the Canadian economy in 1984, unemployment remains just below 11% with close to 1.4 million Canadians unable to find work. At the same time, the government estimates a federal deficit of just under $ 36 billion Cdn.[1] for 1984-85, equal to 8.5% of Canada's gross national product.

In the face of these problems, Mr. Wilson had adopted a cautious approach. On the one hand, he has proposed various measures designed to encourage investment in the Canadian business sector and particularly in small and medium-size business which is viewed as the most important source of potential job creation. However, the Minister has also proposed various revenue increases and expenditure reductions, the net effect of which would be to reduce the federal deficit somewhat, to approximately $ 34 billion Cdn. for 1985-86 and $ 33 billion Cdn. for 1986-87.

The Minister has not proposed any fundamental restructuring of Canada's fiscal plan. The federal deficit is expected to remain large throughout the next 6 years, both in absolute dollars and relative to GNP.

In addition, while the unemployment rate will edge down from recent levels, it is still projected to average 8.5% during 1987-90. These are sobering projections for Canadians and a clear signal that additional action will ultimately be required.

Certain of the more significant Budget proposals are outlined below.[2]

Capital gains exemption for individuals

Canadian taxpayers have, since 1972, been taxable on one-half of capital gains net of capital losses. The Budget now proposes that individuals other than trusts be allowed a tax exemption for net taxable capital gains realized after 1984, to a cumulative lifetime exemption of $ 250,000 Cdn. (effectively $ 500,000 Cdn. of capital gains). The exemption is to be phased in over 6 years in accordance with prescribed rules. For most individual taxpayers, a limit of $ 10,000 Cdn. will apply in 1985, increasing to $ 250,000 Cdn. by 1990. The exemption will not be available to corporations nor, based on our most recent discussions with the Canadian Department of Finance, to individuals resident outside Canada.[3]

This measure is intended to encourage risk-taking on the part of individual Canadians and is a broadly-based incentive which will apply to investments in most capital assets. It is the author's view, however, that an exemption restricted to investments in Canadian business and securities would have been more effective in stimulating the job creation which the government seeks.

Investments by tax-exempt plans

An enormous amount of capital has been accumulated in tax-exempt Canadian funds, including registered pension plans and other retirement income plans. The Minister has proposed several measures to give small and medium-size Canadian business access to this investment capital and at the same time to relax certain restrictions related to investments in foreign property by such plans.

First, registered retirement savings plans and registered retirement income funds would be permitted to invest up to 50% of their assets in shares of arm's length Canadian-controlled private corporations. Second, registered pension plans would be permitted to establish special tax-exempt corporate vehicles to encourage investment in shares or debt of qualifying Canadian

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[1] This amount does not account for additional provincial government deficits. While final amounts have not yet been established for 1984-85, these had originally been projected to aggregate approximately $ 8 billion Cdn.

[2] The reader should note that the Budget proposals are not yet law, that enabling legislation is not yet available for review and that certain of the proposals may be revised prior to their enactment.

[3] Non-residents of Canada, both individuals and corporations, may be subject to Canadian tax on dispositions of prescribed "taxable Canadian property", subject to treaty exemption.

businesses.[4] Also, retirement income plans would be entitled to establish limited partnerships to facilitate other, similar investments in Canadian business.

The Budget also proposes that registered pension plans and other retirement income plans be allowed to increase their investments in foreign property in certain circumstances. At present, such plans are restricted to a maximum foreign property holding of 10% of assets and a penalty tax of 1% per month is charged on any excess foreign property. Under the Budget, pension funds would be allowed to make $ 3 of additional investment in foreign property for each $ 1 of qualified investment in small Canadian business. As a separate measure, shares of public Canadian corporations which are convertible to foreign assets would no longer be considered "foreign property" for purposes of this limitation.

Deficit reduction measures

The Minister has proposed both revenue increases and expenditure reductions in an attempt to check the continued growth of the federal deficit. As a result, virtually all Canadians will be sharing a heavier fiscal burden for the foreseeable future. These measures include the following:

- ○ A surtax will be imposed on middle and upper-income individuals for 1985 and 1986, equal to 2½% to 5% (1985) to 10% (1986) of basic federal tax otherwise payable.
- ○ Effective for 1986, personal tax rates, marginal tax brackets and certain social security payments will cease to be fully indexed and will instead be adjusted only to the extent that the annual change in the Canadian Consumer Price Index exceeds 3%.[5]
- ○ The federal sales tax will increase by 1 percentage point effective 1 January 1986 and, effective 1 July 1985, a wide range of consumer goods which were previously exempt will become subject to the tax.[6] Also, excise taxes and duties on alcoholic beverages, tobacco products and fuels will all increase.
- ○ A "temporary" corporate surtax of 5% of federal tax payable will apply for the 18 month period from 1 July 1985 to 31 December 1986.[7] Income eligible for the special small business deduction will be specifically exempt from the surtax.[8]
- ○ A capital tax, deductible for income tax purposes, is to apply on prescribed financial institutions for two years from 1 January 1986 to 31 December 1987, to be based at a rate of 1% to the extent of capital employed in Canada in excess of $ 200 million Cdn.

Non-resident withholding tax

Non-residents are generally taxed at a flat rate of 25% on interest paid or credited by residents of Canada subject to reduction by treaty.[9] However, certain exemptions may apply, perhaps the most important of which relate to interest payable on Canadian government or government-guaranteed obligations and on prescribed long-term corporate indebtedness.[10]

The above exemptions were scheduled to expire effective for obligations issued after 31 December 1985. In line with previous extensions, and to facilitate continued access by Canadian corporations to long-term debt financing at competitive rates, the Minister now proposes that this exemption continue to apply to qualifying debt obligations issued before 1 January 1989.

Government intervention in the economy

The Minister has promised to streamline the government to decrease waste and inefficiency and to reduce the role of government in the economy. In this regard, a decrease of 15,000 individuals employed by the public service is now projected over the next 6 years rather than an increase of 15,000 as previously estimated. The Minister also announced that crown corporations not serving a public purpose would be sold or dissolved and has initially identified 13 such candidates.

Other Budgetary proposals

While by no means an exhaustive list, the Budget documents also include the following proposals:

- ○ In view of the Canadian Charter of Rights and Freedoms and of various recent court decisions, the search and seizure powers of the tax authorities will be restricted. This is an area in which the tax administration has come under severe criticism in the past for its aggressive and heavy-handed practices.

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[4] To target such investments to smaller Canadian corporations, qualified investments would be limited to a maximum of $ 10 million Cdn. to any one corporation or associated group, having total assets of no more than $ 35 million Cdn. and carrying on a prescribed active business.

[5] While it was originally proposed that old age security payments be subject to this proposal, unprecedented and unanticipated pressure by senior citizens has since forced the government to restore full indexing on such payments.

[6] The Canadian federal sales tax is a single incidence levy which applies on all sales of goods produced or manufactured in Canada or imported into Canada unless the goods are specifically exempt or the transactions occur under exempt conditions. The rate of tax is currently 6% for construction goods and cable and pay television service, 13% for alcoholic beverages and tobacco and 10% for all other taxable goods and would increase to 7%, 14% and 11% respectively under the Budget proposals. A previous "temporary" increase of 1 percentage point effective 1 October 1984 has also now been continued indefinitely.

[7] The Minister had originally proposed that the surtax apply for a 12 month period from 1 July 1985 to 1 July 1986. However, when the government was forced to abandon its proposed plan to de-index old age security payments (supra, footnote 5), it financed the increased cost by an extension of the corporate surtax and by further increases in excise taxes on fuels.

[8] The small business generally applies to Canadian-source active business income of up to $ 200,000 Cdn. a year earned by a Canadian-controlled private corporation or associated group. There will, in addition, be a reduction of the surtax for income earned in the Nova Scotia offshore area and the surtax will not apply to investment corporations or non-resident-owned investment corporations.

[9] The rate of tax is also reduced to 15% in respect of interest paid to non-related persons resident in prescribed countries on obligations issued before 1 January 1976.

[10] Long-term corporate indebtedness will generally qualify for exemption if it is payable to a non-related person on any obligation issued after 23 June 1975 provided the Canadian debtor is not required to repay more than 25% of the principal amount within five years from its date of issue (except in the event of failure or default or if the terms of the obligation are changed by legislation or by a court, board or commission).

○ Amounts received after 22 May 1985 as inducement payments or reimbursements (which otherwise might have been exempt from tax in certain situations) will henceforth either reduce the cost of the related property or constitute income subject to tax.

○ The refundable investment tax credit is to be increased for small business corporations and the special 50% investment tax credit for manufacturing and processing assets in designated areas is to be extended one year to 31 December 1986. On the other hand, government grants and third-party reimbursements received after the Budget date will now specifically reduce the base on which the investment tax credit is calculated. In addition, the carryover of investment tax credits will be restricted where control of a corporation changes.

○ Commencing in 1986, individuals will be restricted from deducting losses created by tax depreciation on tax shelter assets used in businesses that provide services.[11] In addition, the government intends to review the use of and transfer of losses, deductions and tax credits between unrelated taxpayers and, until this review is completed, will continue to refuse to provide advance tax rulings in respect of limited partnerships and similar tax shelter arrangements.

○ Amendments will be introduced to restrict individuals from reducing tax by splitting income through the use of direct or indirect loans in favour of spouses and minor children.

○ The government proposes to improve minimum standards for private pension plans under the federal Pension Benefit Standards Act, and to revise (and generally increase) deductible contribution limits to registered retirement savings plans and other retirement income plans during the period 1986 to 1990.

Discussion papers

As part of the Budget documents, the Minister also issued four consultative documents in the form of "discussion papers" for public review.

The first paper deals with a "minimum tax" for high-income individuals and outlines three possible options – an alternative minimum tax, an add-on minimum tax and a limit on the deductibility of prescribed "preference items".[12] The discussion paper does not conclude with any preferred system or specific set of proposals. At the same time, it is becoming increasingly clear that political pressure will force the government to introduce some form of minimum tax effective 1 January 1986 leaving many individuals uncertain as to what the after-tax implications may be of long-term investment decisions taken prior to that date.

A second discussion paper sets out proposals, including draft legislation, which would allow a transfer of losses within a commonly-owned corporate group. The proposed system would permit a corporate group to elect, commencing with taxation years commencing in 1986, to transfer all or any portion of a group member's current year's business loss with a minimum of complexity. With certain prescribed exceptions, a qualifying group would include corporations meeting a 95% voting and equity test. Subvention payments would not be required.

The third paper deals with a possible fundamental change to the Canadian corporate tax system. Under the paper, the basic federal corporate tax rate would be reduced from 36% to 29% or from 15% to 11% in the case of income eligible for the small business deduction.[13] This would be accompanied by a broadening of the tax base through an elimination of certain accelerated tax depreciation deductions, investment allowances and tax credits. The paper does not propose any fundamental reform of the existing and generally favourable foreign affiliate rules related to international income.

The above proposals are intended to simplify the tax system and reduce biases in investment decisions built in by special tax incentives while maintaining (rather than increasing) the current level of government revenue. It is evident, however, that such changes would inevitably favour certain forms of Canadian business (e.g. the wholesale and retail industries) at the expense of others (e.g. capital-intensive industries). It is clear that the government wishes a full public discussion in this area before any firm proposals are developed. However, should analogous U.S. proposals ultimately go forward,[14] there may be pressure on Canada to follow suit to remain competitive.

The fourth and final discussion paper reviews the Canadian federal budgetary process and contains certain proposals to eliminate uncertainty for taxpayers and the government in the conduct of their affairs. The most significant proposals are to fix a period (January-February) each year for the federal Budget and to give Budget measures the force of law for 180 sitting days pending their passage into law which would allow the tax authorities to refund or collect taxes based on those measures.

BUSINESS PURPOSE AND ADVANCE RULINGS

In the 1984 Stubart decision, the Supreme Court of Canada concluded that the lack of a bona fide business purpose was not sufficient basis, in and of itself, to disregard a transaction for Canadian tax purposes.[15]

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[11] While the Budget documents state that this rule is intended to apply to investments in tax shelter assets such as yachts, recreational vehicles, hotels and nursing homes, the provision when ultimately introduced may prove to be of wider application. Analogous rules already apply to both individuals and corporations in respect of investments in real estate and other leasing properties.

[12] In related developments, the Quebec government has proposed a provincial minimum tax commencing in 1986 to be based on a limit on the deductibility of preference items. The government of Saskatchewan has also introduced a limited flat tax effective in 1985.

[13] These rates are the basic Canadian federal tax rates and do not account for additional tax which applies in each of the provinces.

[14] On 29 May 1985, U.S. President Reagan proposed fundamental changes to U.S. income tax laws. The plan is set forth in a 461-page document entitled "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity".

[15] Stubart Investments Limited vs. The Queen: 84 DTC 6305; (1984) CTC 294.

Rather, the Court indicated that a transaction might be defeated where it fell outside the "object and spirit" of the tax statute taken as a whole. Also, the business purpose test may be relevant in considering the possible application of specific anti-avoidance provisions. Further decisions must now interpret and refine the general principles which the Supreme Court has outlined.[16]

In an address to the Annual Conference of the Canadian Tax Foundation in November 1984, the Minister of National Revenue, the Honourable Perrin Beatty, stated that he had directed that the advance rulings service of Revenue Canada should, within the framework of existing law, rule upon proposed transactions submitted by taxpayers with facts similar to those of the Stubart case and that he wished to consult further on more general guidelines for the advance rulings process. Further to these comments, Mr. Perry Anglin, Assistant Deputy Minister, Revenue Canada, made the following remarks on 21 June 1985 during another meeting of the Canadian Tax Foundation:

> The advance rulings service is now, therefore, prepared to consider for rulings cases where there is no "bona fide business purpose". Information Circular 70-6R is being revised to delete the reference to a business purpose requirement in paragraph 2, and its paragraphs (c) and (d) will be replaced with a reference to the interpretative principles and guidelines set out by the Supreme Court in the Stubart case.[17]

TREATY DEVELOPMENTS

The Canadian Federal Secretary of State for External Affairs, the Honourable Joe Clark, announced on 6 July 1985 a series of measures by the Canadian Federal Government in response to apartheid policies on South Africa. Included in those measures is a statement that the Canada–South Africa double taxation agreement will be abrogated.

It is understood that the Canadian Federal Government intends to give notice of its intention to terminate the treaty prior to 30 September 1985, in which case (and in accordance with Article XIII of the treaty), its provisions would cease to apply:

- In South Africa, in respect of any year of assessment beginning on 1 July 1986; and
- in Canada, in respect of any taxation year ending in or after the 1986 calendar year.

In a more positive but somewhat ironic development, the government of Canada has at the same time signed a double taxation agreement with the Union of Soviet Socialist Republics. The text of the agreement is generally patterned on the model Double Taxation Convention prepared by the OECD. The agreement was signed in Moscow on 13 June 1985 and will enter into force upon the exchange of instruments of ratification. Officials in the Canadian Department of Finance feel it unlikely that the treaty will receive Royal Assent in Canada before the middle of 1986. If ratified during 1986, the treaty would generally have effect on or after 1 January 1987.[18]

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[16] See for example the decision of the Federal Court – Trial Division in Consolidated-Bathurst Limited vs. The Queen (85 DTC 5120; (1985) CTC 142), where it was held that, even though a bona fide business purpose had been demonstrated, certain payments made by a Canadian taxpayer to captive insurance companies operating in Bermuda had artificially reduced the taxpayer's income and should therefore be disallowed having regard, inter alia, to a specific anti-avoidance provision.

[17] Information Circular 70-6R sets out Revenue Canada's administrative guidelines in respect of advance income tax rulings and the circumstances under which requests for rulings may be refused.

[18] Article 22 of treaty.

Search and Seizure

A gallimaufry of events relating to the powers of the fisc

By Donald R. Huggett

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INTRODUCTION

In most countries the revenue authorities have wide powers to obtain information from taxpayers and from those who may have knowledge or documentation about their affairs. Commonly known as "search and seizure", these rights have been the subject of intense scrutiny by the courts in the last few years. One of the more famous cases was that involving Rossminster Ltd. [R.V.I.R.C. ex parte Rossminster Ltd. (1979) 3 All. E.R. 385 (C.A.)] in the United Kingdom where a warrant to search and seize was held to be invalid because it did not specify the particular fraud that was suspected. But what probably swayed the Court of Appeal in this case was that the search and seizure process was carried out like a military operation, not only in the offices of the Rossminster group, but also at the homes of the officers and directors. It is reported that the "raid" involved seventy tax and police officials, that it commenced at precisely 7:00 a.m., that wives or children of some officers were confronted with the warrants in the absence of their husbands or fathers, and that virtually every piece of paper (including a 14 year-old's school report) was confiscated (some 12 van loads in all) regardless of whether or not it was relevant. As Lord Denning, Master of the Rolls, said: "As far as my knowledge of history goes, there is no search like it and no seizure since 30 April 1763, when the Secretary of State issued a general warrant by which he authorized the King's messenger to arrest John Wilkes and seize all his papers". So saying, Lord Denning then went on to state: "Once great power is granted, there is great danger in it being abused. It is the duty of the courts to construe the statute to see it encroaches as little as possible on the people of England . . . But it is fundamental to our law that the means adopted to this end should be lawful. The means should not offend against the right of freedom and the elemental right of property". This particular case seems to underscore the fact that in some cases the revenue authorities have greater powers of search than the police have in dealing with criminal matters. While one might argue that policemen's powers to search for evidence are too restricted, there can be no argument that tax evasion is a lesser crime than murder, armed robbery, or trafficking in illegal substances, and that, as a corollary, the powers of the revenue authorities should not exceed those of the police.

WORK PRODUCT IMMUNITY – THE UNITED STATES

Another case of considerable interest, not only to accountants, but, more importantly, to their clients, is that of Arthur Young & Co. [United States v. Arthur Young & Co. – Supreme Court 21 March 1984 – 84-1 USTC 9305, 52 U.S.L.W. 4355] in the United States. In this case the Supreme Court ordered Arthur Young to deliver its confidential "tax accrual workpapers" to the Internal Revenue Service. This case overturned previous decisions which had held that accountants were not obliged to produce these workpapers, at least if they were not an integral part of the documentation used in the preparation of the income tax returns. For those who do not appreciate the significance of accountants' tax accrual workpapers, it may be stated that they are necessary for the determination of the accrual for income taxes in any set of financial statements and that, by and large, they set out all questionable or debatable items, the likely response if discovered by revenue authorities, and an evaluation of the probability of success. These workpapers would be an invaluable asset to the revenue authorities – if properly completed – since they would provide a "road map" to all debatable items found by the auditors and would save immeasurable amounts of time and digging by tax assessors. Since accountants are required to be conservative in passing judgement on financial statements, one would expect the tax accrual workpapers to show the "worst case scenario". Thus, one can understand the tax authorities drooling about the prospect of obtaining such papers. While it was held by the lower courts that there were strong policy reasons for not requiring the production of these workpapers and that they should benefit from a "work-product immunity", the Supreme Court found that it was "unable to discern the sort of unambiguous directions from Congress that would justify a judicially created work-product immunity for tax accrual workpapers". In fact, the Court said that "the very language of Section 7602 (of the Internal Revenue Code) reflects precisely the opposite: a congressional policy choice in favor of disclosure of all information relevant to a legitimate IRS inquiry". It is interesting to note that while every state in the U.S. protects the confidentiality of client-accountant communications, by statute or regulation, the Supreme Court had decided earlier that in spite of such constraints no general accountant-client privilege prevails in federal tax matters.

While there is no point in going through the details which are well known by now, this chronicle of events would not be complete without reference to the Bank of Nova Scotia [In re Grand Jury proceedings: U.S.V. Bank of Nova Scotia (Brady subpoena) 740 F. 2d 817 (11th Circuit, 14 August 1984)]. In this case, the bank – Canadian corporation with a branch in the United States – was ordered by a U.S. Court to deliver documents from its Bahamian subsidiary even though the production of such information would violate the laws of the Bahamas. There is perhaps much more to this case than described here, but the essential point is that the American courts, and presumably those of some other countries, seemingly believe that they have unbridled authority which may be exercised without consideration of other jurisdictions. It is a fearful concept.

CANADIAN CHARTER OF RIGHTS

In Canada, two cases are of particular interest because the search and seizure powers contained in both the Combines Investigation Act and the Income Tax Act were held to violate Section 8 of the Canadian Charter of Rights and Freedoms which states that "Everyone has the right to be secure against unreasonable search or seizure". The Supreme Court of Canada (in Hunter) [Hunter et al. v. Southern Inc., Supreme Court of Canada, 17 September 1984, 84 DTC 6467] and the Federal Court of Appeal (in Kruger) [Minister of National Revenue et al. v. Kruger Inc. et al., Federal Court of Appeal, 30 August 1984, 86 DTC 6478] found that the Charter would be offended, not only by an unreasonable search or seizure or by a statute expressly authorizing a search or seizure without justification, but also by a statute conferring on an authority so wide a power of search and seizure that it leaves the individual without any protection against "unreasonable" searches and seizures. However, it is important to note that the Courts struck down the seizures not because the right to conduct a search or seizure is contrary to the Charter, but rather because the enabling legislation under the Combines Investigation Act and the Income Tax Act is so broad and so easy to invoke that there cannot be any guarantees against or protection from an "unreasonable" search or seizure. In the Hunter case, it was held that the provisions were inconsistent with the Charter largely because they failed to specify an appropriate standard for the issuance of warrants and because they provided for an improper arbiter to issue them. As the Court also said: "the state's interest in detecting and preventing crime begins to prevail over the individual's interest in being left alone at the point where credibly-based probability replaces suspicion". In the Kruger case, the Federal Court of Appeal found that Subsection 231(4) of the Income Act contravenes the Charter because it confers on the Minister, when he has grounds to believe that one particular offence has been committed, the power to authorize a general search and seizure relating to the violation of any of the provisions of the Income Tax Act. This, suggested the Court, is too broad a power which negates the right to be secure against unreasonable search and seizure. As the Court said: "any statute authorizing searches and seizures in certain circumstances must provide for adequate protection against unreasonable ones". Justice Dickson of the Supreme Court put it quite clearly in stating, about Section 8 of the Charter, that: "The purpose is, as I have said, to protect individuals from unjustified state intrusions upon their privacy. That purpose requires a means of preventing unjustified searches before they happen, not simply of determining, after the fact, whether they ought to have occurred in the first place."

OTHER CANADIAN INITIATIVES

The question of search and seizure powers has been a very important topic in Canada, not so much from the legal point of view as to whether or not such powers infringe upon constitutional guarantees, but, more importantly, from the moral or practical point of view. While it is admitted that the Revenue authorities must have some power to investigate fraud, there is some point beyond which the power of the state becomes oppressive and may violate fundamental freedoms. The Progressive Conservative Task Force on Revenue Canada stated in its report on 8 April 1984:

"The Task Force has found that, in many cases, the extremely wide-ranging powers of Revenue Canada to search the premises of taxpayers and to seize documents has been abused. Serious problems have arisen through the use of this power in the course of 'fishing expeditions'. Additionally, the Department has needlessly interfered with business activity through lengthy retention of documents seized from the taxpayers and third parties."

The Task Force also recommended that the solicitor-client privilege set out in the Income Tax Act should be extended to certain communications between a Public Accountant and his or her client.

In May 1985 the Law Reform Commission of Canada issued a lengthy paper on the subject[1] which concluded that the search and seizure powers provided for in the Income Tax Act[2] "go far beyond what is proper" for a non-criminal statute and constitute an excessive inva-

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[1] "Search and Seizure under the Income Tax Act" – Law Reform Commission of Canada – 130 Albert St., Ottawa, Ontario, Canada, K1A OL6.

[2] These powers are contained in Subsections 231(1) and 232(4) which read as follows:

Sec. 231(1) – Any person thereunto authorized by the Minister, for any purpose related to the administration or enforcement of this Act, may, at all reasonable times, enter into any premises or place where any business is carried on or any property is kept or anything is done in connection with any business or any books or records are or should be kept, and

(a) audit or examine the books and records and any account, voucher, letter, telegram or other document which relates or may relate to the information that is or should be in the books or records or the amount of tax payable under this Act,

(b) examine property described by an inventory or any property, process or matter an examination of which may, in his opinion, assist him in determining the accuracy of an inventory or in ascertaining the information that is or should be in the books or records or the amount of any tax payable under the Act,

(c) require the owner or manager of the property or business and any other person on the premises or place to give him all reasonable assistance sion of privacy. The Commission noted that in Australia and the United States only the general criminal search powers are available for investigating income tax violations, and that while a separate regime had recently been introduced in the United Kingdom, it has been the subject of widespread criticism. The report recommended that safeguards be created to protect taxpayers whose records are sought from third parties, but does not recommend that "privilege" be recognized for tax working papers of accountants. This latter recommendation is at odds with a brief prepared by the Canadian Institute of Chartered Accountants in January 1985[3] which recommended that auditors' working papers should not have to be made available to the tax authorities, except in cases of fraud. In this regard the Institute pointed out that the working papers are prepared as a result of an obligation imposed upon the auditor, not the client, in order to express an opinion on the financial statements; and that the working papers belong to the auditor, not the client, and therefore are not a part of the business records of the taxpayer.

The Federal Budget of 23 May 1985 recognized some of these concerns and provided for amendments to the search and seizure powers in the Income Tax Act so as to:

a) require prior judicial authorization before officials can enter a dwelling house;
b) require prior judicial authorization before any documents can be seized;
c) limit the demand for information from third parties in relation to unnamed persons only where a judge has been satisfied that such information is for the purpose of verifying compliance, that there is reason to believe that one or more persons failed or may fail to provide such information and that the information is not otherwise more readily available.
d) provide for procedural safeguards similar to those found in the Criminal Code in respect of all searches and seizures.

While the Canadian experience does not necessarily overlap or provide a precedent for other countries, a wealth of material has been generated which might be of great value to those considering the problem. In particular, the study paper prepared by the Law Reform Commission[4] and the submission prepared by the Canadian Institute of Chartered Accountants[5] referred to earlier provide some excellent background material.

PRIVILEGE

It is well established in common law that a form of "privilege" exists between a solicitor and his client. The origins of this privilege may be somewhat obscure, but the purpose was to allow the client to "tell all" to his or her solicitor so that the latter could properly defend his client or advance his cause. This privilege is enshrined in the Canadian Income Tax Act which exonerates a lawyer from a charge for failing to give information or produce documents if he establishes to the satisfaction of the Court that he believed that a client of his had a solicitor-client privilege and that he so informed the Minister of National Revenue or his agent. Solicitor-client privilege is defined in the Act as "the right, if any, that a person has . . . to refuse to disclose an oral or documentary communication on the ground that the communication is one passing between him and his lawyer in professional confidence . . ." Inasmuch as "solicitor-client privilege" is referred to, and defined, in the Income Tax Act, it is presupposed that no other "privilege" exists.

However, it is worth noting that the code of ethics adopted by regulation by the *Ordre des Comptables Agréés du Québec* provides in Article 3.02.25 that "A member is bound to professional secrecy and he may not disclose confidential information revealed to him by reason of his position or profession, unless he is authorized to do so by the person who confided such information to him or by an express provision of law". It is not clear whether the code of ethics of the Ordre, which is promulgated by official regulations of the Quebec Government, overrides any demand under a Federal statute since there is an overlapping jurisdiction. Perhaps accountants in Quebec will be subject to the same pressures as the Bank of Nova Scotia which was precluded from divulging information about a customer under Bahamian law, but was nevertheless required to produce it under United States law. Or perhaps the courts in Canada will hold that provincial laws can be overridden by a Federal statute without express provisions to that effect.

This doubtful situation in Quebec may not be of much relevance in other countries, but it does point out that privilege generally does exist for the legal profession, but not others. With more and more tax advice being generated by accountants or other tax advisors it may be time to consider whether or not the fundamental reasons for granting privilege to lawyers do not also apply to certain other professions. While history and practice may govern the results in any particular coun-

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with his audit or examination and to answer all proper questions relating to the audit or examination either orally or, if he so requires, in writing, on oath or by statutory declaration and, for that purpose, require the owner or manager to attend at the premises or place with him, and

(d) if, during the course of an audit or examination, it appears to him that there has been a violation of this Act or a regulation, seize and take away any of the documents, books, records, papers or things that may be required as evidence as to the violation of any provision of this Act or a regulation.

Sec. 231(4) – Where the Minister has reasonable and probable grounds to believe that a violation of this Act or a regulation has been committed or is likely to be committed, he may, with the approval of a judge of superior or county court, which approval the judge is hereby empowered to give on ex parte application, authorize in writing any officer of the Department of National Revenue, together with such members of the Royal Canadian Mounted Police or other peace officers as he calls on to assist him and such other persons as may be named therein, to enter and search, if necessary by force, any building, receptable or place for documents, books, records, papers or things that may afford evidence as to the violation of any provision of this Act or a regulation and to seize and take away any such documents, books, records, papers or things and retain them until they are produced in any court proceedings.

[3] "Protection Against Disclosure of Auditors' Working Papers" – The Canadian Institute of Chartered Accountants, 150 Bloor St. West, Toronto, Ontario, Canada, M5S 2Y2.

[4] See note 1.

[5] See note 3.

try, it may be time to examine the issue in depth, not so much from the legal point of view, but, more importantly, from the point of view of what is proper.

ACCOUNTANTS' PRIVILEGE

Without doubt, the revenue authorities require, and should have, reasonably broad powers of search and seizure or other means of obtaining information. On the other hand, individuals and corporations are entitled to some measure of protection against the unwarranted or unreasonable exercise of these powers. Standing between these two extremes is the question as to whether or not third parties should be involved. This is not an easy question. It is well accepted that an employer must report the amount of salaries or wages paid to employees and that payors of other kinds of income, such as interest or dividends, must also divulge the amounts to the tax authorities. On the other hand, it is not considered "cricket" for the tax authorities to require banks or stockbrokers to provide them with the details of their clients' transactions, at least on a global basis. Thus, in James Richardson & Sons, Limited [v. M.N.R., Supreme Court of Canada, 21 June 1984, 84 DTC 6325], the Supreme Court of Canada ruled that the tax authorities were not entitled to go on "fishing expeditions" and require a third party to provide information about all of its customers. However, it is worth noting that the decision of the Supreme Court did not preclude the authorities from demanding such information where it is relevant to a genuine and serious enquiry concerning a specific person or persons. But perhaps more important an issue is whether or not the tax authorities are entitled to obtain, in addition to factual records of transactions, certain "soft" information relating to a taxpayer's intentions or the reasoning that preceded a transaction. This kind of information is generally available only from solicitors, accountants, tax consultants, or some other professional advisors. The accountant, however, is in the "hot seat" because, in the performance of his duties, he is expected to know, or be informed about, all transactions relating to the business and the purpose thereof. As well, as an advisor, he will be privy to the thought processes that preceded any relevant transactions and the alternative ways of presenting them. Moreover, the accountant is likely to record this information for his own purposes and protection with the result that a considerable amount of additional information may be available from this source. If, historically, solicitors have been able to claim privilege because of "professional confidence", as do doctors and clergymen, then it is wondered why this concept has been denied to accountants.

A STRONG CASE

A strong case can be advanced in favour of some form of privilege for accountants and tax consultants. This was recognized by revenue officials in Canada as long ago as 1975 when they concluded a "gentleman's agreement" with the accounting profession to use demand powers only in cases of strict necessity and even then, except in cases of fraud, to use the information provided only with respect to issues that were previously determined. The agreement also stated that it was not the policy of the officials to request access to accountants' working papers generally or to scrutinize them in the course of conducting a field audit. Judging from the comments of the Progressive Conservative Task Force on Revenue Canada, it would appear that some definitive legislative safeguards should be enacted to protect accountants from incursions by the revenue authorities. Apart from the self-serving arguments in favour of privilege, there are a number of other issues which strongly support it. As auditors reporting upon financial statements, the accountants must have a full and frank disclosure from their clients of all transactions. Where a client believes that the information he provides to his auditor may also be made available to the fiscal authorities it is quite clear that the information may not be as complete as would otherwise be the case, or that it might be slanted for tax purposes. Not only would such a situation strain the relationship between an auditor and his client, but it might also have a detrimental effect upon the quality of financial reporting. The consequences from the loss of the client's confidentiality expectations might be more damaging in the long run than any immediate gain in tax revenues. Insofar as tax accrual workpapers are concerned, to require accountants to reveal them would be to require them to do the job for the authorities (at the expense of the taxpayer himself!). Naturally, such a situation cannot be countenanced. While it is true that the auditor is charged with a public responsibility that transcends any employment relationship with the client insofar as the financial statements are concerned, it is also true that the accountant fulfills a very valuable role as advisor and confidant to management. If this professional confidence is broken, nobody would gain, least of all the revenue authorities. The situation is exacerbated by the fact that lawyers generally enjoy some form of privilege and are now very active in the tax field. Thus, it would seem imperative that some degree of privilege be accorded to accountants if one is to maintain a balance between the rights of taxpayers as citizens and the rights of the fiscal authorities to collect the proper amount of tax. Or, to put it another way, if the concept of privilege is recognized as a legitimate protection for the taxpayer, it should surround the taxpayer and those from whom he receives counsel. To distinguish one from another, based upon education or professional qualifications, is discrimination that is not justified nor defensible.

It is not easy to balance the rights of the state against the rights of individual citizens. Nevertheless, it is time to curb the virtually open-ended search and seizure powers of the revenue authorities. To the extent that they exceed the rights of the police, they must be done away with. To the extent that there is no review or appeal procedure to prevent unwarranted searches, such must be provided. And, to the extent that any search or seizure must be properly authorized by competent and impartial authorities, such procedures should be instituted. And, of course, some form of privilege should be accorded to accountants to ensure that the self-assessment system works. It can only work if citizens are assured of some degree of protection from unreasonable incursions upon their privacy and property and are reasonably confident that their trusted advisors are not stool pigeons. To balance the opposing interests will be a neat trick.

CONCLUSION

If one wanted to restate the obvious in succinct terms one might pronounce that:

a) The revenue authorities must have search and seizure powers in order to enforce the taxing statutes, but these powers cannot be greater than those available to the police in dealing with criminal matters.
b) Any such powers granted must conform with the strictures of any constitutional or basic rights and must, therefore, be provided only by impartial adjudicators with proper safeguards of appeal against unreasonable use or abuse.
c) Because surprise and immediate seizure are essential to the process, provisions must somehow be made to prevent scrutiny of any seized information by the revenue or other authorities until such time as the seizure is considered to be lawful and proper.
d) The seizure of information from third parties should be severely limited and should be confined to factual transactions and information that the taxpayer is required to maintain.
e) The privilege accorded to solicitors should be extended to accountants or other recognized tax advisors, except to the extent that such information can be considered to be an integral part of the records that the taxpayer would normally maintain himself. Specifically, tax planning memorandums, tax accrual workpapers, and any other information of a non-transactional nature should be excluded from the search and seizure process.

While the foregoing might give the appearance of unduly clipping the wings of special investigators, there is merit in prescribing the rules of the game (in order to balance individual and state rights) and in providing properly enforceable procedures which will not be struck down in their entirety because they are too broad. The interest of the state would be better served if it advanced a less than perfect case, but had a chance of succeeding, instead of gathering airtight evidence only to have it rejected because the collection thereof offends the standards of propriety. It may thus be said that the proper administration of our laws (be they tax or other) requires an acceptable code of conduct rather than abusive powers coupled with toothless procedures. As the saying goes, "half a loaf is better than none" and this goes as much for those attempting to stamp out fraud as for those attempting to reduce the size of the shovel put into their stores.

GABON:

New Withholding Tax on Services Rendered by Foreigners

by Michel Lecerf

Gabon has instituted a new 10% withholding tax[1] effective as from 1 January 1985 on payments for services rendered by foreign individuals and entities. The new withholding tax is applicable even where no legal ties (such as parent-subsidiary) bind the purchaser and the foreign supplier of services.

Subject to the new withholding are individuals or companies having no permanent establishment in Gabon but who supply services in the following areas:

- industrial property rights (patents, trademarks, know-how);
- independent professionals (artists, architects, medical personnel, attorneys, etc.);
- technical services (research, maintenance or repair of equipment, technical assistance, especially in computer programming, etc.).

The head office share of expenses invoiced to a branch in Gabon, expenses (at cost) incurred by employees temporarily assigned to Gabon and billed to their company and brokerage and rental fees paid in Gabon for office space situated in Gabon are exempt from this tax.

The new tax is to be withheld at source by the Gabon resident (individual or company)[2] purchaser of taxable services and remitted to the Treasury within the first 15 days of the month following the month of payment for such services. A delay in remittance is subject to a penalty of 10% and non-remittance to a penalty of 100% of the tax due.

Notably, payments to French suppliers of services will not be subject to this tax until ratification of an appropriate amendment to the France-Gabon double taxation treaty.[3]

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[1] Gabon General Tax Code, Art. 143(3).

[2] An individual is deemed resident of Gabon if he habitually resides therein. A company is resident if its head office, principal place of management or a permanent establishment is located in Gabon.

[3] Currently, foreign entities and individuals doing business in Gabon are subject to the progressive tax rate for non-commercial profits and/or to the turnover tax of 15% as applied in the internal tax system.

Statement
on the OECD Report of 6 July 1982 on Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure

By the Institut der Wirtschaftsprüfer (IDW) (Institute of
German Chartered Accountants), Federal Republic of Germany

The report "Transfer Pricing and Multinational Enterprises" adopted in 1979[1] *by OECD has, after publication, been implemented into the domestic law of several countries. As these national regulations have different and diverging contents, there is an increasing danger that double taxation will arise. IDW is concerned that the taxpayers are exposed more and more to such double charges because there is little opportunity for them to influence harmonized pricing in the OECD countries. Moreover, the OECD Report on "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure"*[2] *did not substantially improve the position of taxpayers and their consultants involved in international activities. We are therefore compelled to submit our comments on the 1982 Report.*

I. STARTING POSITION

For the taxpayer, problems arise in transfer pricing if the transfer prices result in double taxation. Such double taxation is based on three fundamental factual events:

1. The agreed price complies with the tax law of the country of origin but at the same time departs from the tax law of the recipient countries.
2. The agreed price complies with the tax law of the recipient country but departs from the tax law of the country of origin.
3. The agreed price departs both from the tax law of the country of origin and the tax law of the recipient country. Here, there are two sub-cases:
   - the agreed price complies with the tax law of other OECD countries (e.g. when apportioning expenses generated by managerial centres of a group of companies or in the case of chain transactions in which several OECD countries are involved);
   - the price has been agreed upon irrespective of the tax law of one of the OECD countries involved.

   It is only in the last sub-case that the taxpayer has disregarded the tax law of all OECD countries involved. In all other cases he has adhered to the tax law of one or more of the countries involved. If the price has been adjusted in one of the OECD countries by the fiscal administration it then complies with the tax law of at least one of the states involved.

II. RESPONSIBILITY FOR DOUBLE TAXATION

If pricing does not comply with the tax law of at least one of the OECD countries involved, the contracting parties engaged in a transaction are responsible for any deviation therefrom.

Insofar as the relevant pricing in one country is considered inadequate by another country and the latter therefore makes an adjustment which results in double taxation, the responsibility for such double taxation, IDW believes, can no longer be with the contracting parties. Even if they adopt the adjustment made by one of the countries they conflict with the rules enforced in the other country. If the price provisions of the different countries do not correspond, the contracting parties are faced with the dilemma that if they adhere to the pricing provisions of one country they automatically depart from those of the other country, or even of several other countries.

IDW is of the opinion that double taxation arising despite this compliance with the tax law of one of the OECD countries involved is outside the responsibility of the contracting parties because they cannot influence the pricing provisions in the different countries: these pricing provisions emerge from governmental action. Such double taxation should be exclusively the responsibility of the OECD countries themselves. Just as, according to the wording of item 27 of the Report, it is clearly unacceptable for "tax authorities to conform to the action of other tax authorities over whom [the member states involved] have no control", it is unacceptable for the contracting parties to be victims of unharmonized policies of conduct by two or more states.

IDW therefore cannot agree with the conclusions of the Report (item 115(i)) that the responsibility for minimizing double taxation is, in the first instance, with the taxpayer. On the contrary, the responsibility for avoiding double taxation is, in the majority of cases, with the tax authorities involved.

III. MEASURES TO AVOID DOUBLE TAXATION

In order to avoid double taxation various measures are

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[1] OECD, Transfer Pricing and Multinational Enterprises. Report of the OECD Committee on Fiscal Affairs (1979).

[2] OECD, Transfer Pricing, Corresponding Adjustments and the Mutal Agreement Procedure. Report of the OECD Committee on Fiscal Affairs (1982).

possible. In this statement we only comment on the following measures:

1. Harmonization of pricing provisions.
2. Implementation of the concept of international comity.
3. Development of the mutual agreement procedure.
4. Introduction of an arbitration procedure.

IV. HARMONIZATION OF PRICING PROVISIONS

All member states of OECD accept the arm's length principle[3] which makes pricing by independent third parties the criterion of the correct transfer price between associated enterprises. But, with regard to the substance of this principle and its application in a particular taxpayer's case, considerable differences of opinion did and do exist amongst the different states. This diversity of opinion has been considerably reduced but not removed by the pioneer report of the Committee on Fiscal Affairs of OECD, "Transfer Pricing and Multinational Enterprises". In its recommendation of 16 May 1979 the OECD Council, aware of these differing opinions, instructed the Committee on Fiscal Affairs "to pursue its work on issues pertinent to transfer pricing and to the assessment of taxable profits of associated enterprises in general". It was the aim of this recommendation and the therein given instruction to harmonize the tax law of the OECD countries in the area of transfer pricing, in order to achieve "consistency in the approaches of the tax authorities, on the one hand, and of associated enterprises, on the other hand, in the determination of transfer pricing" (preamble of the recommendation by the Council of 16 May 1979). Up to the present this purpose has not only not been achieved, but developments have rather taken the opposite direction.

After 1979 Italy[4], Germany[5] and Denmark[6] issued their own regulations on the arm's length principle. There exist as well the U.S. regulations on Sec. 482 IRC[7] and partial regulations in France[8] and in Great Britain[9]. Moreover some other countries, amongst them Canada, have prepared national regulations which are already considerably advanced.

All these national regulations are indeed based on the arm's length principle and take into account – though to a differing extent – the OECD Report of 1979; thus in principle there is a high degree of conformity. But in the detailed regulations relating to the practical case they widely diverge. As the tax authorities are bound to their own regulations, such deviations result, in practice, in double taxation.

Moreover there is a danger that, internationally, the application of the arm's length principle is becoming more and more unclear; disharmonization is the result. If this process continues the multinational enterprises will be faced with a situation more difficult than the situation before the publication of the OECD Report of 1979. Before that point, many tax authorities were not yet fixed with regard to their attitude on this subject. Reasonable pricing could therefore be implemented in the majority of the states. If, as is currently the case, the number of states which implement national regulations increases and these national regulations often deviate from each other, pricing according to uniform principles becomes nearly impossible.

Therefore IDW proposes that OECD request all states which already published a national regulation on the arm's length principle or which intend to publish such regulation to submit their regulations, as a non-obligatory working document, to the Committee on Fiscal Affairs of OECD. In cooperation with industry and associations this committee should try to prepare harmonized and uniform price regulations which are enforced in all states in the *same* manner. Simultaneously OECD should ask all states which have their own regulations to treat them, for the time being, as non-obligatory. Until the coming into force of a uniform OECD regulation the tax authorities should not be bound by national provisions.

V. PRINCIPLE OF INTERNATIONAL COMITY

During the IFA Congress 1975[10] in London the applicability of the principle of international comity for taxation was discussed[11] and included in the final resolution of this congress[12]. This principle states that "for a decision in the individual taxpayer's case, foreign taxation must be taken into account" with the consequence that the tax authority must also be prepared "to withdraw its tax claims, if possible at the outset, when there is danger of double taxation".[13]

The following recommendations of the OECD Report of 6 July 1982 are the outcome of this principle – even if not *expressis verbis* stated:

- in the cases where a rule under Art. 9(2) of the OECD Model Convention (arm's length pricing) has been agreed upon, the tax authority shall be obliged to approach the competent authority of the other state in case of impending double taxation (item 74);
- to extend this to cases in which a rule under Art. 9(2) of the OECD Model Convention is absent (item 79);
- to reduce the time limit of mutual agreement procedures by appropriate measures (items 83, 87);
- to strengthen personal discussions in cases of divergent opinions (item 92);
- to urge the Internal Revenue Services of the countries concerned to coordinate statements of investigation (item 95);

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[3] Art. 9(1) OECD Model Taxation Convention on Income and Capital (1977).

[4] Circular No. 9/2267 of 22 September 1980.

[5] Administrative principle IV C5-S1341-4/83 of 23 February 1983.

[6] Auditing Manual No. 330-5309-9 of 10 June 1983.

[7] Treasury Decision 6952 of 15 April 1968.

[8] Note 4 A-2-1973 of 4 May 1973.

[9] Schedule 9 Oil Taxation Act of 1975 and Guidance Notes of 1981.

[10] International Fiscal Association Congress, September 1975.

[11] General Report, Cahiers de droit fiscal international, Volume LX b 1975, p. I/69.

[12] IFA Yearbook 1975, p. 46.

[13] General Report, op.cit.

- to notify the enterprises concerned at a stage as early as possible of the intended adjustments in order that discussion between these enterprises and the tax administrations concerned can be started (item 102).

These recommendations are certainly appreciated, but it must be argued that they do not suffice. The divergent interpretation of the arm's length principle and the non-coordinated application in the individual taxpayer's case, reinforced by the increasing number of national regulations, are exclusively the responsibility of the tax administrations concerned; the taxpayers have no influence in this context (cf. under item II above). It is therefore not sufficient to notify the taxpayer of the intended adjustment and then leave him primarily with the problem of coordination.

The tax administration which by a planned adjustment could generate double taxation should also be required to avoid such double taxation. The tax administration should not be allowed to leave the taxpayer to his own resources but should assist him with all means available. It therefore must give active assistance, must approach the other tax administration involved and endeavor to find a solution for the double taxation conflict, even if a rule under Art. 9(2) of the OECD Model Convention has not been agreed upon. If such efforts remain, finally, without result, the tax administration which intended an adjustment must also be prepared to withdraw its plans. Only such behavior is in line with the principle of international comity. At any rate, it should not be permitted to impose on the taxpayer the burden of existing differences of regulation arising from the interpretation of the arm's length principle.

VI. DEVELOPMENT OF THE MUTUAL AGREEMENT PROCEDURE[14]

The Report adheres (in items 34 and 70) to the explanation of the OECD commentary on Art. 9(2) of the Model Convention (paragraph 3) under which, when introducing a mutual agreement procedure, there is no obligation to agree and, if agreement has been reached, there is no obligation to implement the mutual agreement result. In this way the mutual agreement procedure as a measure to avoid double taxation is considerably devalued. It supposes a coordinated opinion of the states concerned and by this effect fails simply on the fundamental factual events, referred to in the introduction, events which affect the taxpayers most vigorously. The Report also contradicts the resolution taken by the IFA Congress 1981 in Berlin[15] (IFA Yearbook 1981 p. 63) under which the taxpayers have a right to obtain a binding solution for the avoidance of double taxation and an obligation is imposed upon the competent authorities to pursue negotiations so as to reach agreement. In the opinion of IDW an implementation of this IFA resolution is imperative and also possible, as under item 40 of the present OECD Report acceptable compromises for all states concerned have, in practice, nearly always been found. Moreover, it is not persuasive that a possible conflict with national law be interposed as a reason not to recognize an obligation to agree. All OECD member states accept the arm's length principle (item 39); to this extent the law is already harmonized. Its concretisation has, however, been effected by diverging administrative instructions and concepts.

Additionally, if the tax administrations are in a position to set up general regulations for pricing they should also be able to reach an agreement in a particular taxpayer's case.

Procedural problems (relation of the mutual agreement procedure to the remedies procedure, legal force of assessments and prescription facts) are not contrary to a mutual agreement and its implementation: such difficulties should be removed by good will.

Moreover, the difficulties for the administrations will be reduced if, in accordance with our above mentioned suggestion, the already existing national regulations are treated as not obligatory prior to the issuance of coordinated provisions. The development of uniform principles should, contrary to item 70, take preference over bilateral solutions.

To the extent that – as in the case of apportionment of expenses by centralized management – the tax law of several states is affected, this seems indispensable.

However, the following issues included in the Report seem to be appropriate in order to improve the mutual agreement procedures:

- general acceptance of the principle of avoidance of "economic" double taxation (item 74 et seq.);
- domestic procedural rules for the taxpayer with regard to the introduction and execution of mutual agreement procedures (items 106-108) including the clarification of the relation between the mutual agreement and remedies procedures (items 112/113);
- speeding up the process (item 71);
- publication of mutual agreement results, safeguarding confidentiality (item 114);
- removal of time limits (item 80 et seq); and
- consultation with independent persons (item 35).

VII. ARBITRATION PROCEDURE

The Report shares (in items 41 and 42) the opinion already expressed[16] several times by IDW that, with regard to a more intensive examination of transfer prices by the administrations, the number of mutual agreement procedures will considerably increase. Now is the time to introduce an arbitration procedure. The Report has doubts on the urgency of such a procedure (items 39/60), but the fact that since approval of the OECD Report in 1979 a number of states have published non-harmonized regulations should, in our opinion, be sufficient proof that because of the missing coordination of such principles the number of double taxation cases

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[14] Art. 25 of OECD Model Double Taxation Convention, op.cit.

[15] International Fiscal Association Congress, September 1981.

[16] Statements sent to the Federal Minister of Finance, 1 September 1977, 22 January 1979, 5 March 1980 and 27 January 1983.

must necessarily increase. We therefore cannot agree on the delaying treatment proposed in the Report (item 63). Moreover, we do not share the fundamental fears expressed in the Report that such a procedure might be abused (item 49). The remote possibility of abuse is not a reason to prevent the necessary arbitration procedure.

IDW is not ignorant of the fact that difficulties relating to particular issues exist (relation to remedies procedures, appointment of impartial arbitrators etc.). These difficulties can, however, be resolved.

Editor's comment:

It should be noted that the OECD 1984 Report, "Transfer Pricing and Multinational Enterprises, three taxation issues" (OECD Committee on Fiscal Affairs (1984)), contains the same wording as the 1979 Report and has made no progress in this area.

Conference Diary

NOVEMBER 1985

Management Centre Europe: Leasing (including the role of taxation in leasing. Brussels (Belgium), 5-8 November (English).

European Study Conferences Limited: Bank Taxation and Developments. London (United Kingdom), 7 November (English).

European Study Conferences Limited: Setting Up & Runing Non-resident Companies (including: tax havens and controlled foreign company provisions; double tax relief and double tax agreements). London (United Kingdom), 7 November (English).

Oracle Business Information: The Construction Industry and Property Development. A practical approach to VAT planning. London (United Kingdom), 8 November (English).

European Study Conferences Limited: Value Added Network Services. London (United Kingdom), 8 November (English).

The American Tax Institute In Europe: 8th Annual Congress; New Developments in U.S.-European Taxation (including: U.S. tax reform proposals affecting international transactions; French international tax developments; international tax treaties). Cannes (France), 13, 14 and 15 November (English).

European Study Conferences Limited: VAT – Dramatic Changes and Perpetual Oversights. Glasgow (United Kingdom), 14 November (English).

Seminar Services International: Holding and Finance Companies (including: tax treaties and tax planning). Amsterdam (Netherlands), 14 and 15 November (English).

European Study Conferences Limited: VAT – Dramatic Changes and Perpetual Oversights. Bristol (United Kingdom), 21 November (English).

Seminar Services International: International Tax Planning (including: international legislation to counter the use of tax havens). Amsterdam (Netherlands), 21 and 22 November (English).

European Study Conferences Limited: VAT – Dramatic Changes and Perpetual Oversights. Birmingham (United Kingdom), 28 November (English).

Oracle Business Information: Taxation of Life Offices (including: taxation of life assurance business; taxation of investment transactions). London (United Kingdom), 28 November (English).

Seminar Services International: Doing business in Switzerland (inclduing: Switzerland; tax haven?). Zurich (Switzerland), 28 and 29 November (English).

DECEMBER 1985

British Branch of I.F.A.: Taxation aspects of investment into Spain and Gilbraltar. London (United Kingdom), 2 December (English).

European Study Conferences Limited: 7th Annual ESC Conference on International Transfer Pricing for Multinationals. London (United Kingdom), 3 December (English).

European Study Conferences Limited: 8th Annual North Sea Continental Shelf Taxation Conference. London (United Kingdom), 5 and 6 December (English).

European Study Conferences Limited: How to Manage Corporate Taxes. London (United Kingdom), 6 December (English).

European Study Conferences Limited: How to Dispute Revenue Decisions. London (United Kingdom), 11 December (English).

Management Centre Europe: Financial Planning and Control (including: transfer pricing). London (United Kingdom), 9-12 December (English).

JANUARY 1986

British Branch of I.F.A.: Current developments and proposed changes in U.S. taxation. London (United Kingdom), 14 January (English).

SEPTEMBER 1986

40th Annual Congress of I.F.A.: I. Transfer of assets into and out of taxing jurisdiction. II. Currency fluctuations and international double taxation. New York (U.S.A.), 7-12 September (English, French, German, Spanish).

FOR FURTHER INFORMATION
PLEASE WRITE TO:

The American Tax Institute In Europe, 14 rue Jean Mermoz, 75008 Paris, France.

British Branch of I.F.A., P.O. Box 68, Unilever House, Blackfriars, London EC 4P 4BY, United Kingdom.

European Study Conferences Limited, Kirby House, 31 High Street East, Uppingham, Rutland, Leics LE 15 9PY, United Kingdom.

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

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Oracle Business Information, 21 The Barton, Cobham, Surrey, United Kingdom.

Seminar Services International, Boulevard de Pérolles 7a. CH-1700 Fribourg. Switzerland.

INTERNATIONAL FISCAL ASSOCIATION NEWS

FAREWELL MR. LAXAN

On 13 September 1985 Mr. Max Laxan's presidency of IFA came to an end. During the 4 years IFA had the honor of being led by such an eminent scholar and tax practitioner very successful congresses were held as far apart as in Montreal (Canada) in 1982, Venice (Italy) in 1983, Buenos Aires (Argentina) in 1984 and London (the United Kingdom) in 1985. Mr. Laxan was able to further enhance the prestige of IFA and thus caused the number of IFA members to grow from about 6,000 in 1982 to approximately 7,000 in 1985. In recognition of Mr. Laxan's services to IFA he was unanimously elected Honorary President, a honor which he has richly deserved.

WELCOME MR. HAMMER

On 13 September 1985, after having been chosen President-elect in 1984, Mr. Richard M. Hammer (age 55) was nominated President of IFA. Mr. Hammer graduated from Harvard Graduate School of Business Administration in 1953 and joined Price Waterhouse in 1956. Within 10 years he was made partner and was appointed National Director of International Tax Services in 1979. In 1982 he was nominated Chairman, PWWF International Tax Services Panel. In addition to his daily activities as partner of Price Waterhouse, Mr. Hammer heads or has headed a great number of tax committees. He is, among other things, currently Chairman of the Tax Committee of the U.S. Council for International Business, of the Tax Committee of the U.S. Business and Industry Advisory Committee to OECD and he is Vice Chairman of the Fiscal Committee of the Business Industry Advisory Commitee to OECD. Mr. Hammer has in the past presided over the Tax Society of New York University, the U.S.A. Branch of the International Fiscal Association and the International Tax Association. He is a member of the Investment Policy Advisory Committee of the U.S. Trade Representative, of the Steering Committee of the Special Committee for U.S. Exports, of the International Taxation Committee of the World Trade Institute, of the Advisory Committee of the Southwestern Legal Foundation, of the AICPA (he is a past Chairman of its International Tax Committee and of its Task Force on International Tax Policy), and of the New York State Society of CPAs (he is a past Chairman of its International Taxation Committee). IFA is proud to have a President with such vast experience in the international tax field who will undoubtedly contribute much to IFA's prestige in international tax circles.

Some Highlights from the Secretary General's 1984-85 Annual Report Presented at the London Congress 1985

IN GENERAL

The Secretary General points out that IFA is still a healthy organisation so that membership fees could be reduced. A problem, however, is constituted by the ever increasing registration fees for the annual congresses. IFA has now drafted a questionnaire which will be mailed to all IFA members (or a representative group among them) to find out what delegates expect from their congresses. It is hoped that the information obtained will enable IFA to determine where there is room for change and thus find ways to reduce or eliminate unnecessary factors which are pushing up congress fees.

BUENOS AIRES CONGRESS

The 38th IFA Congress took place in September 1984 in Buenos Aires. It was one of the most successful IFA congresses and IFA is particularly indebted to Prof. E.J. Reig, Dr. A.R. Lopez, Dr. A. Schindel and Dr. V.O 'Diaz whose efforts can hardly be overestimated.

With respect to Subject I – *"Fiscal obstacles to the international flow of capital between a parent and its subsidiary"* Mr. J. Rebizo (Argentina) was the Chairman of the Working Session, Prof. A. Fantozzi (Italy) the Discussion Leader, Prof. Dr. K. Vogel (Germany) the General Reporter and Messrs. Humberto Petrei (Argentina), G. Beatty (U.S.A.), C. Hall (Hong Kong) and J.W.B. Westenburgen (the Netherlands) were the Panelists.

With respect to Subject II –*"Social security contributions as a fiscal burden on enterprises engaged in international activities"* Mr. R. Asorey (Argentina) was the Chairman of the Working Session, Mr. G.L. Herring (Australia) the Discussion Leader, Prof. Dr. E.J. Reig and Dr. J. Macón (Argentina) the General Reporters and Messrs. B. Lessu (France), D. Horsley (Canada), E. Gnazzo (Panama) and B. Villard (Sweden) were the Panelists.

The Seminar on *"Adjustments for tax purposes in highly inflationary economies"* was chaired by Dr. A. Schindel (Argentina) and the Panelists were: Dr. Ives da Gandra Silva (Brazil), Mrs. Milka Casanegra de Jantscher (Chile; member of the IMF), Mr. A. Yoran (Israel), Mr. Walter Rossi Bayardo (Uruguay) and Mr. G. Balzarotti (Argentina).

NATIONAL BRANCHES

At the Buenos Aires Congress a new Branch of Peru was recognised, which brings the total of IFA Branches to 35. IFA has now approximately 7,000 members. Contacts were made with IFA members of Paraguay and Venezuela and it is hoped that soon IFA Branches in these countries may be welcomed.

News is welcome from the National Branches about their workshops, bilateral meetings, joint seminars etc., since this is forwarded to the International Bureau of Fiscal Documentation, Amsterdam, for insertion in the IFA News Column in the BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION.

PERMANENT SCIENTIFIC COMMITTEE

The Committee regrets to have lost two eminent colleagues, Prof. Stanley Surrey (U.S.A.) and Mr. S. Ambalavaner (Sri Lanka). Their untimely deaths are a great loss to IFA.

Mr. André Gauthier (Canada) was appointed as a new member.

The Committee developed further ways of improving working sessions. Firstly, the procedure of nominating reserve speakers to the working sessions will be discontinued and it will be left to the discussion leader to find suitable speakers from the floor. Secondly, the voting on amendments to resolutions following the rules of procedure of the U.N. General Assembly was found to work well. However, the Committee found that submitting of amendments in writing on the Friday afternoon before the start of discussions on the resolutions would further improve this procedure.

EXECUTIVE COMMITTEE

The Executive Committee reached unanimous agreement on a proposal to be made to the General Council and the General Assembly at the London Congress to nominate the outgoing President, Mr. Max Laxan, an Honorary President of IFA.

IFA will celebrate its 50th anniversary in 1988. In honour of this event a jubilee book entitled *"IFA 1938 – 1988 – The First Fifty Years"* will be written by Mr. W. Dirksen (the Netherlands), who is a retired tax expert and historian. The Executive Committee is also considering the publication of a booklet containing all past resolutions adopted by IFA.

MEMBERSHIP FEES

For the year 1985 the contribution was:
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 National Branches.
For 1986 no change is proposed.

MITCHELL B. CARROLL PRIZE 1984

Mr. Charles Kalinijabo (Rwanda) won the Mitchell B. Carroll prize 1984 for this work: "Le rôle et la structure des impôts au Rwanda" (The role and the structure of taxes in Rwanda). An Honorable Mention was awarded to Mr. Mohammed Marzak for his work: "Le régime fiscal des bénéfices des sociétés françaises au Maghreb" (The tax treatment of profits of French companies in the Maghreb).

LONDON CONGRESS 1985

At the time of writing the 1984-85 Annual Report, preparations for the London Congress were nearing completion. The Congress venue is in the Barbican Centre in the City of London. Hotels have been reserved in the West End. Delegates received free weekly tickets for the London Undergound so that transportation to the Congress Centre will not be difficult.

The officers for the Congress:

Mr. J.S. Phillips and Mr. M. Collins (U.K.) are General Reporters for Subject I – *The assessment and the collection of tax from non-residents.*

Mr. W.S. Goodman (Canada) is the General Reporter for Subject II – *International double taxation of inheritances and gifts.*

Discussion Leaders are Mr. D. Tillinghast (U.S.A.) for Subject I, and Mr. R. Koch-Nielsen (Denmark) for Subject II. Chairmen of the Resolutions Committee are Prof. Dr. G. Laule (Fed. Republic of Germany) and Mr. G. Delorme (France) for Subject I and II, respectively.

Seminar A *(International tax problems of charities and other private institutions with similar tax treatment)* is chaired by Mr. J.D.B. Oliver (U.K.) and Panelists are Dr. K. Neuhoff (Fed. Republic of Germany), Mr. T. Miyatake (Japan), Mr. A. Feder (U.S.A.) and Mr. M. Benoit (Canada).

The U.K. Branches will be holding three further seminars: Seminar B will deal with: *"Interpretation of tax treaties – conflicts caused by reference to internal law"*; Seminar C will be on *"Tax aspects of new types of financing transactions"*; Seminar D will treat the subject of *"Recent changes in U.K. Corporation Tax – investments from and into the U.K."*

FUTURE CONGRESSES

1. New York Congress 1986

The subjects for the New York Congress 1986 were selected:

Subject I: *Transfer of assets into and out of a taxing jurisdiction* (General Reporter Mr. Y. Kergall (France)).

Subject II: *Currency fluctuations and international double taxation* (General Reporters: Mrs. M. Burge and Mr. P. Farber (U.S.A.)).

2. Brussels Congress 1987

The subjects for the Brussels Congress 1987 are:

Subject I: *The concept of resident corporations* (General Reporter Dr. J. Rivier (Switzerland)).

Subject II: Tax problems of liquidation of corporations (companies) (General Reporter Prof. G. van Fraayenhoven (Belgium).

3. Amsterdam Congress 1988

Preliminary discussions were held.

BRITISH BRANCH

On 20 June 1985 the British Branch of IFA held its Annual General Meeting during which the Chairman, Mr. David Davidson, presented his report on the Branch's activities over the past year. On 31 March 1985 membership consisted of 351 individual and 121 corporate members and 29 more had joined since that date. Eight branch technical meetings had been held with attendance between 50 and 80. An extra meeting on China was arranged to complete the 1984/85 session. Five technical meetings had been held by the Manchester Sub-Branch. About 20 Branch members attended the 1984 Congress in Buenos Aires. With respect to the activities for 1985/86, dates for the first meetings – the separate consideration of National Reports for the New York Congress – and for the Wine Tasting have already been fixed for 23 September, 3 October, and 8 November respectively.

Topics suggested for technical meetings included Spain and Gibraltar, developments in U.S. taxation – particularly on double taxation relief, the taxation of expatriates both coming to and leaving the U.K., Japan, the application of the Keith proposals – particularly those on income tax, recent tax cases, and OECD documents on central cost allocation and treaty shopping. It was suggested that during 1986/87 a joint seminar be held with another branch or branches.

With respect to the election of Branch Committee Members and the appointment of officers the Chairman explained that Mr. Harlow had resigned and that under the transitionary rules of the election procedure Messrs. Clarke, Davidson, Duncan, Gammie, Phillips and Tapper retired at the meeting. The same six members and Mr. Eric Tomsett were nominated to fill the seven vacancies and in the absence of other nominations the Chairman declared these members to be elected to the Committee. He also told of the Committee's intention to appoint Mr. Michael Smart, who had agreed to join.

CANADIAN BRANCH

Meeting on tax treaties and international taxation;
Report by Robert Couzin, Stikeman, Elliott, Toronto

The Canadian Branch organized a Seminar held in Ottawa on 14 May 1985. Over 100 Branch members attended the day-long meeting. Most speakers were government officials who provided a helpful and candid view of treaties and related matters from the official perspective.

The first paper was presented by Jean-Marc Déry, Chief of the Tax Treaty Group in the Department of Finance. Mr. Déry has been personally involved in the negotiation of many of Canada's treaties, and discussed the status of such negotiations. His paper served to update participants regarding the situation of pending negotiations and included a detailed description of some particular issues currently under consideration. The prepared materials will enable participants to assess the current status of Canada's treaty network with great facility.

The next speaker, also from the Department of Finance, was Ron Wilson, then acting Chief of the Corporate Legislation Group. His presentation related not so much to tax treaties but rather to various technical issues arising out of the interaction of different tax systems. Some of these matters would, of course, arise in the context of bilateral treaties. For example, Mr. Wilson discussed at some length difficulties co-ordinating the ACT system of the United Kingdom with rules in Canadian law relating particularly to the calculation of surplus of foreign affiliates. Treaty related issues included difficulties regarding foreign tax credit in dealing with high tax treaty partners or potential partners, such as India, and the exemption system for distributions from foreign affiliates which arises in respect of treaty partners with special incentive legislation, such as Barbados.

One subject of interest to many practitioners was the interaction of the various national systems for imputing passive or other income of foreign affiliates. For some years, Canadian practitioners have grappled with the potential overlap of the U.S. "subpart F rules" and the Canadian version under the acronym FAPI (foreign accrual property income). With the introduction of U.K. rules to similar effect, although designed on yet another pattern, potential practical issues arise more often. As well, the U.K. system raises serious tax policy issues about how best to construct such an imputation mechanism.

The only non-governmental speaker was Joseph H. Guttentag of Arnold & Porter, Washington, D.C., and a member of the U.S. Branch. Mr. Guttentag was invited to address the Canadian Branch on matters of concern to them in the U.S. approach to tax treaties arising in particular out of certain recent U.S. revenue rulings relating to Netherlands Antilles finance companies. Those rulings in effect disregard the finance companies in certain cases for purposes of applying the U.S.–Netherlands Antilles treaty. In light of the significant intercourse between Canada and the United States, and the use of certain favoured investment holding structures, there has been concern as to how these rulings could affect the U.S. taxation of various types of distributions. For example, could the new attitude affect the payment of dividends or interest by a U.S. company to a Netherlands holding or finance company which is in turn owned by a Canadian parent? It does seem clear that the IRS will seek to extend the ambit of these rulings to other treaties and other transactions. However, the precise scope of the policy is yet to be seen. Generally, it appears that various back-to-back equity/loan structures could be subject to challenge on this basis.

In addition to presenting his own paper, Mr. Guttentag was a most valuable commentator on the several Canadian papers, providing an "outside" perspective for members of the Canadian Branch.

In the afternoon, speakers were invited from the Department of National Revenue which administers the Canadian tax system, while the Department of Finance is charged with formulation of policy and presentation of tax changes. The first Revenue speaker was John A. Calderwood, Director of the Tax Avoidance and Foreign Operations Division. He presented a comprehensive paper regarding competent authority practice, which also dealt with the official views on exchange of information provisions. Mr. Calderwood summarized the procedures which are required to commence and carry out a competent authority consideration of a taxation matter arising in the treaty context, and also described in some detail the actual experience of his Department in dealing with such procedures. He summarized the types of settlements which have been reached, the attitude towards alternative remedies and gave some indication of the workload of his Department in this regard, both as to the number of cases, the countries involved, and the nature of the issues. The overall impression is that the competent authority practice is not greatly used, likely because the types of issues which would otherwise be considered are settled earlier in the administrative process, that when it is used the vast majority of cases involve U.S.–Canada issues and that the most common substantive matters which give rise to competent authority cases are imputed interest and transfer pricing.

Finally, Carol J. Muirhead, Chief of Non-Resident Business and Property Income in the Non-Corporate Rulings and Publications Directorate and Keith Harding of the Provincial and International Relations Division of the Tax Policy Directorate, both of the Department of National Revenue, provided a stimulating presentation in the form of a series of questions and answers. These questions had been submitted in advance to them. The organizers of the Seminar had solicited and received questions from a number of members of the Canadian Branch. Indeed, such questions were also provided to other participants who replied to them in the course of the Seminar. In the case of Miss Muirhead and Mr. Harding, the questions related to specific problems in tax treaty interpretation. Most of the questions went to the recent Canada–U.S. treaty. Some were highly technical while others were more general in scope. Subjects ranged from the administrative withholding requirements in Canada to various income characterization issues, treatment of tax exempt institutions under certain treaty provisions and a number of definitional problems which have arisen in interpreting Canada's treaties.

Certain prepared remarks and outlines as well as some of the question and answer material has been distributed to those members of the Canadian Branch who registered for the Seminar. This material plus certain other portions of the proceedings not yet available will be published in book form later this year and distributed free of charge to all members of the Canadian Branch. Other IFA members who are interested in purchasing the booklet should correspond with the Secretary of the Canadian Branch, Mr. Helmut Birk, c/o Thorne, Riddell & Co., 630 Dorchester Blvd. West, Montreal, Quebec, H3B 1S6.

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 51-52 of the January 1985 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Botswana

TAX INFORMATION SUMMARY.
Gaborone, Coopers & Lybrand [P.O. Box 294], 1985. 45 pp.
Incorporating 1985 Budget Proposals and an outline of Exchange Control Regulations. Summary of the tax proposals tabled in the National Assembly on 18 February 1985.
(B. 13.288)

CAPITAL TRANSFER TAX.
Gaborone, Coopers & Lybrand [address see above], 1985. 6 pp.
(B. 13.289)

Ghana

STATEMENT BY PNDC
Secretary of Finance and Economic Planning on economic performance in 1984 and highlights of the 1985 Budget.
Accra, Ministry of Finance, 1985. 9 pp.
(B. 13.287)

Morocco

MOROCCO.
Industrial Incentives and Export Promotion. A World Bank Country Study.
Washington, The World Bank, 1984. 219 pp.
Report prepared by economic mission that visited Morocco in 1982 analyzing the development of the country's manufacturing sector, including a review of industrial incentives and taxation.
(B. 13.291)

South Africa

VAN DER S. HEYNS, J.
Towards a tax expenditure budget for South Africa.
Occasional Paper No. 15,
Durban, Economic Research Unit, University of Natal [King George V Avenue, Durban 4001, Natal], 1984. 124 pp.
(B. 13.285)

Tunisia

REVUE TUNISIENNE
de droit 1982.
Chief editor Moncef Ben Slama.
Tunis, Centre d'Etudes, de Recherches et de Publications de la Faculté de Droit et des Sciences Politiques et Economiques, 1982. 1070 pp.
Compilation of articles and documents (including tax reform included in the Five-Year Plan 1982-1986).
(B. 13.286)

ASIA & THE PACIFIC

ECONOMIC AND SOCIAL
survey of Asia and the Pacific 1984.
Bangkok, United Nations, 1985. 207 pp., $ 19.00.
Thirty-eighth annual edition of study, presenting in Part One a survey of recent economic and social developments in the region in the context of the world economic situation. Part Two aims to analyze the problems of financing developments in the countries of the region.
(B. 56.616)

Australia

TAXATION EXPENDITURES.
Report from the House of Representatives Standing Committee on Expenditure.
Canberra, Government Printer, 1982. 41 pp.
(B. 56.629)

NEW TAX INCENTIVES
for research and development.
Canberra, Ministry for Industry, Technology and Commerce, 1985. 8 pp.
Press release.
(B. 56.630)

Bangladesh

NEW INDUSTRIAL POLICY.
Dacca, Ministry of Industries and Commerce, 1982. 12 pp.
(B. 56.619)

GUIDE TO INVESTMENT
in Bangladesh.
Dacca, Department of Industries [22 Purana Paltan, Dacca - 2], 1983. 45 pp.
(B. 56.618)

China (People's Rep.)

A BUSINESSMAN'S INTRODUCTION
to China.
New York, Arthur Young [277 Park Avenue, New York, NY 10172], 1984. 39 pp.
Introductory information for interested persons who want to do business in China. Taxation is dealt with.
(B. 56.631)

TAX & INVESTMENT PROFILE.
People's Republic of China.
New York, Touche Ross International [One World Trade Center, Suite 9300, New York, NY 10048], 1985. 22 pp.
Introduction to doing business in and with China, with particular emphasis on the taxation of foreigners.
(B. 56.622)

Hawaii

BAHL, Roy; WEIST, Dana.
Fiscal projections for the State of Hawaii.
Occasional Paper No. 96.
Syracuse, Syracuse University [Syracuse, New York], 1985. 101 pp., $ 3.00.
The paper is designed to answer the question of what growth in State tax revenues is needed to accommodate public expenditure.
(B. 106.311)

Hong Kong

WILLOUGHBY, P.G.
Hong Kong Revenue Law.
Taxation of Income. Volumes 2 and 3.
New York, Matthew Bender, 1985. 724 pp.
Loose-leaf publication in two volumes providing information on the taxation of income. An outline and annotated text of the statutes is followed by text of interpretation and practice notes, etc.
(B. 56.627)

WILLOUGHBY, P.G.
Hong Kong Revenue Law.
Estate duty. Volume 1.
New York, Matthew Bender, 1984. 560 pp.
Loose-leaf publication providing an outline of the Hong Kong Estate Duty Law followed by an annotated text of the Estate Duty Statute.
(B. 56.627)

India

SAMPATH IYENGAR, A.C.
The Law of Income Tax.
A commentary on the Income-tax Act, 1961.
Seventh edition. Volume Four, Sections 139-234.
Allahabad, Bharat Publishing House [15, Mahatma Gandhi Marg, Allahabad 211 001], 1984. 1124 pp.
Annotated text of Secs. 139-234 of the Indian Income Tax Act 1961 as amended, in Volume 4 of a commentary on the Income-tax Act.
(B. 56.624)

SAMPATH IYENGAR, A.C.
The Law of Income Tax.
A commentary on the Income-tax Act, 1961.
Seventh edition. Volume Five, Sections 235 to end.
Allahabad, Bharat Publishing House [address see above], 1985. 416 pp.
Annotated text of Secs. 235 to end of the Indian Income-tax Act 1961 as amended, and section-wise commentary.
(B. 56.614)

RAMACHANDRAN, T.A.;
RAMACHANDRAN, Janaki.
The Gift Tax Act, 1958 and The Gift Tax Rules, 1958 with explanatory notes and statement of principles derived from Indian and foreign decisions. Second edition.
Madras, Company Law Institute of India Private Ltd. [88 Thyagaraya Road, Madras 600 017], 1985. 442 pp.
(B. 56.625)

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(B. 106.197)

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(B. 106.130)

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Düsseldorf, IDW-Verlag, 1985. 1051 pp., 49 DM.
Annual guide containing the text of the Wage

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(B. 106.181)

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Umsatzsteuergesetz, Durchführungsverordnung, Anlagen, Rechtsprechung, Nebengesetze, Stichwortverzeichnis, Richtlinien.
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(B. 106.015)

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Düsseldorf, IDW-Verlag, 1985. 339 pp., 26 DM.
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(B. 106.227)

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Peter van den Broek:

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The Structure and Developments of Socialist Tax Law from a Western Point of View*

By W.G. Kuiper

Willem G. Kuiper is a principal research associate of the International Bureau of Fiscal Documentation and also coordinating editor of *Guides to European Taxation, Vol. 5, Taxation in European Socialist Countries*, published by the Bureau.

I. INTRODUCTION

The subject proposed for my lecture is a very broad one on which little has been published and which, therefore, lends itself to a personal point of view. It is also a subject which, by implication, suggests a comparative analysis of socialist and non-socialist tax systems.

In 1955, the American economist, Dr. Franklin Holzman, wrote in "Soviet taxation"[1] that "Soviet taxation is a neglected field of study". Even as late as 1978, his complaint was repeated by the American lawyer, Professor Paul Jonas,[2] who wrote that "no comprehensive work has been published by any Western author on the structure and working of Soviet-type fiscal measures". Although Jonas' complaint was not quite accurate (in this respect, I particularly would like to mention the excellent study by Wilczynski, entitled "The economies of socialism",[3] published in 1970, who also discusses the theoretical principles which are necessary to understand the socialist tax systems), times have drastically changed since, particularly by the publication of the comprehensive loose-leaf service *Taxation in European Socialist Countries*, commenced in 1981, by the International Bureau of Fiscal Documentation in Amsterdam.

Mr. Jonas also mentioned, and quite rightly, that the understanding of the socialist tax systems and their effects in practice would require a comprehensive comparative study. Only then would a comparison of socialist and non-socialist tax law be possible.

II. CRITERIA OF INVESTIGATION

However, more is necessary than a mere comparative analysis of the socialist tax systems, i.e.

(1) an understanding of socialism itself;[4]
(2) a satisfactory method of comparison;[5] and
(3) an explanation of the practical importance of such a comparison, and that as seen through Western eyes.

In my opinion, it is, within this scope, not necessary to discuss the concept of socialism, all the more because it is very difficult to define this term and because most definitions neglect one important feature of socialist economies: the existence of a centrally-planned economy. Therefore, it would be better to formulate the first criterion of investigation as "the effects of socialism on the economy and on taxation".

The two most important features of the centrally-planned economies in European socialist countries are, arguably, the 5-Year Plans and the budget laws. The budget laws act as a link between the 5-Year Plans and the plans for production and financing of the State enterprises whereby the taxation of these enterprises must – at least partially – be considered as an instrument to realize the goals set by the 5-Year Plans.[6] Sometimes tax rates are annually changed in accordance with the Plans. It is undeniable that this, in itself, reflects an enormous difference between socialist and non-socialist tax law, the more since over 75% of tax revenue is derived from State enterprises. To give some scope to the subject, it is significant to note that in most socialist States this difference remains further undiscussed because there is no possibility of a real comparison without a discussion of the political aspects thereof.

This limitation basically means that a comprehensive comparison between the tax systems in socialist and non-socialist countries, as well as a judgement on the various aspects thereof is not possible, because some important aspects are not taken into consideration, e.g.:

(1) the impact of the influence of the State on the course of economic processes through tax formulas in relation to the economy as a whole;
(2) the government policy with respect to revenue and expenditure as a component of State activities; and

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* Text of lecture presented at 7th Conference of Socialist Financial Lawyers in Cluj, Romania, 12-17 May 1985.

[1] Holzman, F., Soviet Taxation: The Fiscal and Monetary Problems of a Planned Economy, Cambridge: Harvard University Press (1955).

[2] Jonas, P., Taxation of Multinationals in Communist Countries, New York, Preager Publishers (1978), at 5 et seq.

[3] Wilczynski, J., The Economies of Socialism, London, Allen Unwin, 1970.

[4] See Stern, L.M., Taxation in East European Countries, an Introduction, in: 20 *European Taxation*, 4 (1980), at 106.

[5] See Haase, H.E., Einkommensteuern im Ost und West (Income taxes in East and West), in: *Ost-Europa Wirtschaft*, 2 (1981), at 8 et seq.

[6] See Lavigne, M., Les économies socialistes soviétiques et européennes, Paris, 3rd ed. (1979), at 334 et seq.

(3) the role of the State in using taxation as an instrument to control investments.[7]

From these considerations, it must be concluded that the development of a tax formula which could, at least formally, be used for purposes of comparison must be waived. For the same reason, it is not possible to formulate alternatives which can be used for purposes of comparison. Therefore, I will make no attempts to discuss both tax systems in their entirety, but only the taxation of private households and of foreign investors. Moreover, even such a partial comparative analysis can only cover some aspects of the form and function of these taxes.

III. TAXATION OF PRIVATE HOUSEHOLDS

Although there is no satisfactory method to compare both tax systems in their entirety, there are numerous efforts in financial literature to compare the taxation of private households in various States with each other.[8] However, this does not extend as far as a comparative analysis of the tax laws of socialist and non-socialist countries. Perhaps this is due to the fact that there is no *general* "socialist tax doctrine", or, at least, that such a doctrine is in a primitive state of development. This is illustrated by the statement of Bielig and Falk,[9] "without any exception, taxes should be levied on all income and wages and, from a socialist point of view, progressive income and net worth taxes are the only correct taxes". This lack of a general tax doctrine in economic and financial science is perhaps one of the most important differences between socialist and non-socialist countries.

A. Wage taxes

The consequences of the lack of a general socialist tax doctrine are evident in the "Taxes on Population" as levied in socialist countries, at least when considered from a Western point of view. One of the best and most illustrative examples to support this view is the fact that, in most socialist countries, there is no general wage tax; for example, in Poland and Romania, there is no wage tax levied on workers employed in the socialist sector. On the other hand, employees in Hungary and in the German Democratic Republic must pay social security contributions whereas employees in other socialist countries do not pay such contributions. The fact that only certain groups of the population are subject to a specific tax whereas other similar groups are not subject to that tax or are subject to another tax is, to say the least, remarkable from a Western point of view and may be attributable to the absence of a general socialist tax doctrine.

The above should not be construed as a general Western criticism of the socialist tax system; such criticism would disregard the function of taxes (and especially that of the wage tax) in a socialist society.

B. Schedular taxes

There are other, more essential differences between income taxes in socialist and non-socialist countries. For example, in most Western countries, the income tax has been developed as a general "tax on ability to pay"[10] levied on the aggregate income of taxpayers, whereas in most socialist countries (with the exception of Poland and, to a certain extent, Hungary) tax is imposed by applying separate tax laws to various categories of income. In this respect, employment income is subject to a wage tax, the rates of which are considerably lower than in Western countries.

On the other hand, capital income and rental income are normally taxed at extremely high rates in socialist countries. Thus, at the same time, tax rates in socialist countries are among the lowest and the highest ones. This differentiation of taxes according to sources of income and social status is basically different from the schedular tax systems in Western countries (e.g. Portugal) and many developing countries. Such a differentiation, which can be based on the Marxist philosophy, is not unproblematic; for example, the income earned by a medical doctor in the German Democratic Republic who is employed by the State is subject to wage tax levied at a top rate of 20%, whereas the professional income of his colleague who is not employed by the State is subject to tax (although tax-privileged as compared with other professionals) at a top rate of 30%.[11] It is undeniable that, in both cases, the source of income is from similar activities.

This differentiation leads to enormous complications in the socialist taxes on the population and, at the same time, leads to detailed tax laws which when considered from a Western point of view are, at the least, curious, e.g. the separate tax on income from animal-drawn transportation which is levied in Romania. Without knowing the basis for such separate taxes, one wonders whether such a special tax could be incorporated in an already existing tax law by special provisions or privileges.

The complexity of socialist tax law caused by this differentiation is particularly problematic for foreigners who are temporary residents in a socialist country, or, when not a resident, receive income from sources in that country. They will normally wonder to which tax (or taxes) they are subject with respect to such income and whether there are any alternative taxes to be taken into account. Above all, this applies when, in addition to the separate income taxes on various sources, a tax on "total income" is levied in a certain country, such as in Czechoslovakia, the Soviet Union and Yugosla-

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[7] See Haase, H.E., note 5.

[8] See Neumark, F., Überblick über die Personalsteuern (Overview of personal income taxes), in: *Handbuch der Finanzwissenschaft*, Vol. II, Tübingen (1975), at 317 et seq.

[9] Bielig, W. and Falk, W., Die Rolle der Steuerpolitik für die Entstehung und Entwicklung sozialistischer Machtsverhältnisse (The role of fiscal policy for the origin and development of socialist relative powers), in: *Beiträge zur Geschichte der deutschen Arbeiterbewegung*, 17:6 (1975), at 996.

[10] Andel, N., Einkommensteuer (Income tax), in: *Handbuch der Finanzwissenschaft*, note 8, at 332.

[11] Haase, H.E., note 5, at 94.

via. One questions whether it would be possible for all these separate income taxes to fulfill the role of such a tax on total income, i.e. an equalization of excessive income, or whether the tax on total income could fulfill the role of all these special taxes. The latter case would be a first step towards a global income tax as it exists in most Western countries.

This does not mean that a global income tax system would be ideal. In Western tax law, there is also an ever increasing complexity because of the growing number of special provisions for specific categories of taxpayers and taxable bases for special types of income. Sometimes, Western tax experts wonder whether the income tax systems in their countries can still be considered global because of all these special provisions. In light of this complexity, the efforts of Western governments to achieve a simplification of their tax systems is worthy of consideration. However, there is some doubt as to the success of these efforts. For example, the Dutch Individual Income Tax Law becomes more and more incomprehensible as a result of all sorts of special provisions, particularly since the recent introduction of the tax measures for "dual earners", i.e. members of one family, both (or all) of whom obtain employment income. Nor can the Dutch income tax system be regarded as fully global, e.g. where it concerns the special provisions concerning the taxation of foreign artists.

In most tax laws of socialist countries, the reverse is true; on the one hand, an enormous complexity as a result of the differentiation of taxes, on the other hand a – perhaps over-large – simplification because of the absence of special provisions as usually contained in tax laws of Western countries (e.g. provisions on the deductibility of income-connected expenses or special expenses, provisions on capital gains, loss carry-overs, as well as special provisions for entrepreneurs: e.g. depreciation and valuation of assets, reserves, provisions for liabilities, etc.). Perhaps the income tax laws of Poland and the German Democratic Republic are easiest to understand from a Western point of view. Although there is a separate, rather complicated wage tax in these countries and, in addition, a separate tax on excessive income in Poland, the income tax law itself is rather clear and not very complicated from a Western standpoint. It is applicable to all categories of income (except wages); there is only one tax table; there is a comprehensive list of tax-exempt income; and there are provisions on the deductibility of expenses, losses, depreciation, etc.

Recently, Hungary has also simplified its system of taxes on the population somewhat by the abolition of the special tax on income from "intellectual activities". Instead, such income (i.e. patent royalties, copyright royalties, authors' fees, etc.) is subject to the general income tax which is levied at progressive rates.

On the one hand, this is a most welcome simplification. On the other hand, the special provisions concerning withholding taxes on patent royalties and copyright royalties paid abroad, which were contained in the previous law concerning the tax on income from intellectual activities, have not been included in the general income tax law. Understandably, this has raised questions for foreigners. Therefore, a simplification should not be made for the sake of simplification, it should also take into account the existence of previous special provisions and the incorporation thereof.

C. Family taxation and family allowances

Another remarkable difference between "Eastern" and "Western" systems concerning the taxes in the population is found in the taxation of married couples and the granting of family allowances. In non-socialist countries, there is a relatively low degree of uniformity in this field. In addition to the fully separated income tax assessment of married taxpayers (as in Austria and Italy), most countries apply either a joint assessment or a separate assessment only for earned income or both.[12] It is true that, within the scope of the European Communities, the harmonization and equal treatment of taxation and social security of married persons is being worked on. But up to now these efforts have not been very successful, especially when this results in complicated measures such as the above-mentioned provisions concerning "dual earners" in the Netherlands.

In most socialist countries, taxation of spouses is not used as a specific tool to encourage married women to be professionally active. In general, separate taxation is applied to employment income which is subject to wage tax. However, for purposes of income tax assessment (for other types of income), husbands and wives are taxed jointly. Although, for instance, in Czechoslovakia, spouses are also separately taxed on such other income. Nevertheless, in most socialist countries, the family status is taken into account in one way or another for tax purposes. A very remarkable form of "family allowance" – from a Western point of view – is found in the tax laws of Romania, Bulgaria and the Soviet Union. In these countries, married couples without children are treated as single persons and as such are subject to the "bachelor tax" which is levied in addition to income tax.

In the German Democratic Republic the family status is taken into account for purposes of the wage tax in a form similar to that provided in some Western countries; taxpayers are divided into three separate categories, depending on their social status (i.e. marital status, number of children, etc.), to which different tax tables apply. Another situation is found in Czechoslovakia where the Wage Tax Law as well as the Individual Tax Law contain only one tax table which applies to taxpayers who are responsible for the maintenance of two or three persons. Tax rates are reduced or increased if the taxpayers have to maintain more or fewer persons. In other socialist countries, there is no form of family allowance contained in the tax legislation, unless the bachelor tax would be considered so.

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[12] For an overview, see: *Supplementary Service to European Taxation*, Sec. B, International Bureau of Fiscal Documentation, Amsterdam.

From a chart published some years ago in the periodical *Ost-Europa-Wirtschaft*[13] the conclusion can be drawn that, in Eastern European countries, child allowances are mainly granted through "social relief" payments rather than through tax allowances. As a result, available net income of a married taxpayer with two children exceeds gross income in countries where no wage tax is levied on income from employment in the State sector (i.e. Poland, Romania, and Hungary) as well as in Czechoslovakia whereas in the other countries the available net income, expressed in percentages, ranges from 80 to 92% of gross income. For single taxpayers, the available net income is lower. In OECD countries, the amounts range (for married taxpayers with two children) from 67 to 97% of gross income.[14]

D. Comments

In sum, one can say that available net income, expressed as a percentage of gross income, is much higher in socialist countries than in Western countries. However, a comparison in absolute amounts is impossible. Furthermore, the tax burden on employment income (i.e. wage tax and social security contributions) in the German Democratic Republic is relatively higher than in the other socialist countries whereas the income tax burden in the German Democratic Republic more closely resembles corresponding data in Western countries. One may wonder what specific reasons (from an economic-systematical point of view) there are for this similarity? In general, however, this confirms the impression that the wage and income tax system of the German Democratic Republic, as compared with other socialist countries, is the most developed in Western eyes.

The Polish system of taxes on the population, as far as income tax is concerned, has been developed in a way which more closely approximates Western systems. However, the system of the Polish wage tax appears to be extremely complicated from a Western point of view because it is only applied to wages earned by employees in the non-socialized sector and because there is a large number of different tax tables.

It is difficult to determine whether the abolition of the Hungarian tax on income from intellectual activities is a first step in the direction of a global income tax system. However, it appears that, in this respect, there is a new trend in the system of taxes on the population. It remains to be seen whether this trend will also be followed by other socialist countries.

In this respect, the question of which function taxes on the population have in socialist countries cannot go undiscussed. Concerning this question, Spiller[15] states: "The importance of a tax depends on the nature of the State. Given the priority to material development in socialist countries, taxes are a tool of secondary importance which are particularly used in order to achieve political, economic and social effects. However, they are used in combination with all the other managerial tools of the State and they only form one of the many tools in this respect." Thus, the functional importance of taxes as a managerial tool used by the State exists, but it is limited, at least in comparison with non-socialist countries. Therefore, the question arises, what would be the sense of a change-over to a global income tax system and of a simplification of the income tax system, if any, in socialist countries? One can assume that the importance of income taxation in socialist countries – as opposed to developing countries – will not increase very much. Indeed, a discussion of what would be a "rational tax system" has hardly begun among the representatives of a "socialist financial law".

IV. TAXATION OF FOREIGN INVESTORS

However, the above question must be asked again in light of the current intensification of international economic and tax relations of the socialist countries, with each other and with non-socialist countries.

Within the scope of the increasing tax relations between socialist and non-socialist countries, all socialist countries have concluded one or more double taxation treaties[16] and that number steadily increases. In this respect, Romania is in the lead as it has concluded more than 20 bilateral double taxation treaties with Western industrialized and developing countries. It is a remarkable feature of all these treaties – with the exception of the treaties concluded by the Soviet Union – that they basically follow the pattern of the OECD Model Tax Treaties of 1963 or 1977.

The increasing economic and trade relations between socialist and non-socialist countries are expressed not only by the number of cooperation agreements, but also by the enactment in socialist countries of legislation permitting Western entrepreneurs – under certain conditions – to establish their own representative offices in socialist countries or to conclude a joint venture agreement for the formation of a joint enterprise on the territory of socialist countries. This development has been rather succesful in Hungary and Yugoslavia.

Given these developments, the question arises more and more, how are these representative offices and joint ventures taxed in socialist countries, because they too form a category of taxpayers outside the socialist sector.

At present, although the establishment of representative offices of Western enterprises is allowed in all socialist countries, the taxation of these offices, which are generally regarded as permanent establishments in the sense of double taxation treaties – and therefore

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[13] Haase, H.E., note 5, at 97.

[14] Ibid.

[15] Spiller, H., and others, *Finanz- und Währungsbeziehungen zu nicht-sozialistischen Ländern* (Financial and currency relations to non-socialist countries), Berlin, Staatsverlag der D.D.R. (1984), at 130.

[16] For an analysis of double taxation treaties in socialist countries, see W.G. Kuiper, East-West Tax Treaties, in 15 *European Taxation* 6 (1975), at 185. For treaties currently in force, see *Guides to European Taxation*, Vol. V, *Taxation in European Socialist Countries*, section 13, International Bureau of Fiscal Documentation, Amsterdam.

the profits of which are subject to tax in socialist countries – has not been set forth in a very detailed manner. The same more or less holds true for the taxation of joint ventures which are currently allowed in five socialist countries. In this respect, the main question is: how are taxable profits of representative offices and joint ventures computed?

For example, in the Bulgarian Decree on the establishment of joint ventures[17] it is provided that taxable profits should be computed on the basis of the annual balance sheet (and not, as is usual in the West, on the basis of the annual profit and loss account). From a Western point of view, this wording does not clearly state which business expenses are deductible for tax purposes, nor which criteria should be applied for purposes of valuation and depreciation. Moreover, there are no provisions concerning compensation of losses, tax deductible reserves and provisions, treatment of capital gains, etc. The same can be said on the taxation of representative offices set up in Bulgaria. Perhaps many of these questions can be answered on the basis of provisions in other laws. However, this important information is not accessible to the Western investor. The same objection can be raised against the joint venture legislation in Romania,[18] as well as the legislation concerning representative offices in Czechoslovakia, Romania and the Soviet Union.

Although the laws concerning the taxation of joint ventures in Poland[19] and Hungary are more detailed, a number of important questions also remain unanswered. From a systematical point of view, the taxation of joint ventures in Poland appears to be the most developed, and that because there is no separate income tax law which applies to joint ventures. Generally, the income tax on the population also applies to joint ventures. And, as stated already above, Polish income tax law is relatively detailed as regards questions which are important for foreign investors. In particular, the law contains provisions concerning accounting, the valuation of income-in-kind, capital gains, deductible and non-deductible business expenses, as well as an explanation of which rental and capital income is subject to tax. Deductible business expenses explicitly include, e.g., reserves for bad debts and the depreciation of fixed assets (according to the straight-line method). Non-deductible expenses include, among others, dividends (which is rather remarkable in socialist tax law), as well as the discounts granted by legal entities to their shareholders, and the value of other supplies without charge to shareholders. Particularly the latter category, which is similar to the concept of hidden profit distributions in the West, is almost unique in the tax law of a socialist country.

The Hungarian Decree on the Corporation Tax and the Special Corporation Tax on foreign companies and companies with foreign holdings[20] also contains some specific provisions on the taxable profits. The Decree explicitly provides that profits must be computed on the basis of the annual profit and loss account (and not on the basis of the balance sheet, such as in Bulgaria and Romania). Moreover, the Decree specifically mentions a number of factors which influence the taxation or taxable profits where they differ from the profits according to the profit and loss account, i.e. a carry-forward of losses, depreciation, adjustments in the valuation of fixed assets, bad debts, etc.

Again, although the provisions in the Polish and Hungarian laws on the taxable base of the income tax on joint ventures, as well as foreign companies doing business in these countries, are rather detailed, there are still a number of – for Western investors – important questions which either remain unanswered or can only be answered by reference to other laws which are not, or only rarely, accessible to Western investors. Some of these are:

(1) What are the valuation principles for current assets?
(2) What depreciation methods are allowed?
(3) What depreciation rates are applicable?
(4) Where relevant, is there a carry-over of losses and, if so, for how many years can losses be carried back or forward?
(5) What tax-free reserves and liability provisions are allowed (e.g. guarantee obligations, old age pensions, etc.)?
(6) How are currency fluctuations treated?
(7) How are (in Hungary) capital gains and losses treated and is there an adjustment for inflation?

The answer to some of these questions can be found in other laws. For example, for depreciation of fixed assets the Hungarian law refers to the relevant provisions for State enterprises. Such references are not very clear, however, and therefore of no practical use for a Western investor, particularly because there are major differences between the tax treatment of State enterprises and the usual tax treatment in the West. Another possibility is that, for certain matters, there is some degree of contractual freedom, but such contractual freedom is only applicable to joint ventures and not for other foreign investors. Moreover, it cannot be determined in advance whether contractual agreements will be approved by the authorities.

In connection with all these questions, one very important aspect should not be overlooked, i.e. whether there are differences in the tax treatment after payment of the income tax or the corporation tax. This involves a discussion of the very complicated area of the economic double taxation of company profits. The profits distributed to the Western partner are, after deduction of withholding taxes levied at the source, normally fully subject to income or corporation tax in the State of residence of the Western partner, unless the affiliation privilege applies. However, where the affiliation privilege applies, the distributed profits are finally taxed in the hands of the shareholder of the Western

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[17] Decree 535 of 28 March 1980 of the Council of Ministers on the Economic Cooperation between Bulgarian Juridical Persons or Individuals.

[18] Decree 425 of 4 November 1972 of the State Council on the taxation of profits of joint companies constituted in the Socialist Republic of Romania.

[19] Decree of 7 July 1982, *Journal of Law* 1982, 19, it. 146. Citation, at 10.

[20] Decree 45 of 1984 of the Minister of Finance on the corporation tax and the special corporation tax.

partner. And here the question arises: what is the tax treatment of the "after tax profits" in the hands of the socialist partner of a joint venture? On the basis of available documentation, it appears that there are rather major differences between the various socialist States. For example, in Poland the after tax profits are fully subject to tax in the hands of the socialist partner; in Hungary, however, they are exempt! And in Romania, the after tax profits are only taxed in the hands of the socialist partner when they constitute "above-plan" profits.

Obviously, the question of the tax neutrality[21] between the Western and the socialist partner which is immediately connected with the tax treatment of the after tax profits is very problematic, all the more because this question is not, and perhaps cannot be, solved by double taxation treaties. In addition to the above-mentioned questions concerning the taxable base and some other questions of a non-fiscal nature, the solution to the tax neutrality issue may be decisive to the attractiveness and the success of East-West business cooperation.

As for the tax treatment of joint ventures in Yugoslavia, the situation is totally different from that in other socialist countries, particularly because Yugoslavia has a non-corporate form of joint venture whereby the foreign partner invests in an existing Yugoslav Organization of Associated Labor and the profits derived from the joint venture are separately taxed in the hands of the partners, in proportion to their share. The provisions applicable to Yugoslav (domestic) Organizations of Associated Labor are effective in determining the taxable base of such joint ventures. The laws which are applied to such organizations contain detailed provisions concerning deductible business expenses, depreciation, valuation questions, etc. However, the question of the economic double taxation of company profits has not been resolved where the foreign partner is a joint-stock corporation or a limited liability company (although, under the double taxation treaties concluded by Yugoslavia, the share in the profits is generally taxed according to the permanent establishment principle). This question is of even more current interest because the profit share of the Yugoslav partner is subject to taxation only once.

Unfortunately, the tax treatment of other forms of foreign investment in Yugoslavia has been provided in a less detailed manner, particularly with respect to the question of the taxable base. Although the taxable base is described as "gross receipts less business expenses and payroll (whereby business expenses are the costs of raw materials and other items used for production of services supplied to the entrepreneur, interest charged and depreciation in the same amounts as valid for Yugoslav enterprises), no provision has been made concerning the application of the Yugoslav valuation law. This is regrettable because some of the provisions contained in the new Yugoslav valuation law[22] are not only very interesting, but also unique among socialist tax laws, in so far as they provide for the valuation of assets on the balance sheet in excess of the purchase or manufacturing costs. The reason behind this being the high inflation rates in Yugoslavia. To my knowledge, this is the only example in socialist tax law where inflation is taken into account.

V. CONCLUSION

Firtstly, we compared some aspects of private households. In this respect, we concluded that the tax systems of the German Democratic Republic and Poland are the most developed from a Western point of view. The tax systems of most other States are rather complicated as a result of the differentiation and, from a Western point of view, a bit "old fashioned". However, perhaps the change-over to a general income tax in some socialist countries is a trend for the future. In any case, such a development would mean a simplification, particularly for non-resident taxpayers. However, should there be such a simplification, one should not leave important questions unanswered. But, neither should one make the same mistake as in many Western countries where simplification remains under discussion while the tax systems as such become more and more complicated.

My conclusion with respect to the taxation of joint ventures and other types of foreign investment is just the opposite. Here, for foreign investors, there are many important questions which remain unresolved, although Poland, Hungary and Yugoslavia have made a step in the right direction. The solution to these questions, however, would certainly mean that taxation, with respect to foreign investors, would become more complicated.

Both my conclusions have two aspects. I see the socialist tax systems and the developments therein both positively and negatively. In doing so, it should be noted that attention herein was only given to fiscal aspects and not to general-economic and socio-political aspects. That would not have been possible within the scope of this subject. Nevertheless, I hope that this lecture has made a small contribution to new developments.

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[21] See for more detail: Vogel, K., *Cahiers de droit fiscal international*, LXIXa (1984) Fiscal obstacles in the international flow of capital between a parent company and its subsidiary, General Report, at 20.

[22] For a discussion of the Yugoslav valuation law, see 25 *European Taxation* 8 (1985), at 242.

AUSTRALIA:

Tax Summit

By Peter van den Broek

An Australian Tax Summit was held on 1 July 1985 under the auspices of the Australian Government. The Summit was attended by representatives of trade unions, employer groups, business, women's groups, taxpayer organisations and of course the Government. The opposition had been invited to attend but declined fearing perhaps to be seen as too negative.

The Summit was called because one of the election promises made by the Hawke Labor Government was to improve the tax system. The Prime Minister, Mr. Hawke, agreed to arrange a Tax Summit at which all major groups in the community would be represented and stated that no changes would be made unless it was shown at the Summit that wide support (meaning more than simply majority support) for change existed.

There has emerged in Australia in recent years a widely accepted view that the tax system is unfair. This view seems to be due to two causes.

Firstly increasing attention has been given to "bracket creep" i.e. the tendency for taxpayers to be pushed into a higher tax bracket as wages rise because of inflation or as the standard of living rises. Large sections of the working population have found themselves in the second highest tax bracket with a marginal tax rate of 45% or even the highest bracket of 60% in the dollar.

Secondly much media attention has been given to tax avoidance. The Costigan Commission, established a few years ago to investigate the affairs of the Builders Labourers Federation, uncovered evidence of large scale tax avoidance by big business. Continued revelations of this kind and resulting prosecutions have helped to maintain the feeling amongst the populace that the wage-earner pays all the tax while the businessman pays nothing.

The basic aim of the Government, in convening a Summit, was to give tax relief to wage-earners, particularly middle to high wage-earners, without disadvantaging low income earners and to fund this relief by a tax thought to be less avoidable.

The Government, to further this aim, put forth its preferred proposals. The thrust of these were to introduce a broad-based consumption tax (as yet Australia has no general tax at the point of sale but only a wholesale tax on goods) of 12.5%, a capital gains tax and sizable reductions in personal income tax to be funded by the consumption tax and the capital gains tax. There was no proposal to decrease company tax and certainly no wide support for such a reduction. There is not a great deal of sympathy for the business sector mainly because of the publicity given to tax avoidance.

Although there had been some criticism of the Government's proposals prior to the Summit, no participant had pre-empted discussions on any issue and the absence of the opposition prevented the affair becoming polarised as is characteristic of Australian politics. The style of the Hawke government is very much one of bringing parties with conflicting interests together to form an consensus. The Prime Minister himself has shown considerable flair in achieving such a consensus. Thus if a conference of this kind could succeed this one should have done so. Sadly, in spite of the possibilities for success, the Summit was a failure.

Firstly the Summit failed to achieve wide support for the Government proposals or to come up with any alternatives for sweeping reforms. The Government was forced to drop its preferred proposals and settled for a much watered down version. The idea of a consumption tax was retained only for services and then only at 6.5% and the existing wholesale tax on goods was to be increased slightly. The capital gains tax was retained but this was expected to produce very little revenue because it excluded the family home and only taxed gains over inflation. Thus the extra revenue could only finance relatively small reductions in personal income tax.

The main criticism of the Government proposals was that a consumption tax favoured the rich because they spend less proportionately on disposable goods and that it would be inflationary. But this is not the principal reason why the Summit was a failure. The Government had always maintained that its proposals were only a basis for discussion.

It failed because no representative group gave serious thought to what was wrong with the tax system and what ought to be done to improve it. Rather they simply criticised the Government proposals in terms of their own sectional interests. Thus the possibilities for serious debate were limited and the Summit quickly deteriorated into a fairly useless exercise.

Some reflection is necessary on why this elaborate experiment failed to articulate the community's thoughts concerning taxation. The reasoning of the Government seems to have been along these lines. Parliament (in Australia at least) is not a place where constructive criticism of government proposals is likely to take place. Thus, to simply introduce the proposals into Parliament would tend to polarise public opinion and impede the process of finding reforms acceptable to the community as a whole. It was essential to achieve wide support in a matter so fundamental as taxation, particularly for the Labor Party, desiring, as it does, to establish itself as the "natural" government of Australia and to replace the Liberal Party in this regard. Because of the power of the trade unions it was especially necessary to have their support but not in a way that would be seen as giving them preferential treatment. If the government held a Summit and obtained wide support it would be shielded from criticism if the proposals failed and would encourage participants of the Summit to

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help the proposals work. In short, major political lobbies would bear some political responsibility for the tax reform rather than having the freedom to criticise reforms without having to make alternative proposals.

However, the major political groups were not prepared to take that risk. The reasons seem obvious. Trade union leaders and the like are not accustomed, nor in fact appointed, to take responsibility for any other interests than those of their members. Even if wider sentiments exist amongst the members, they are unlikely to be expressed by leadership. The glare of publicity would only increase nervousness about appearing to do anything but represent their members' interests in the narrowest sense. Also the fear of bearing responsibility for government policy no doubt weighed heavily on their minds. Public opinion is usually very hard on failure.

It is possible to advance another reason why the Summit failed. The perceived unfairness about the tax system was the burden imposed on middle to high wage-earners but this group had no real voice at the Summit. They are not represented by large and active trade unions nor are they a group with the common identity essential to effective representation. They are public servants, company executives, public corporation employees, employed professionals and the like. The trade union movement is dominated by unions of blue collar workers and there is no other body which could effectively represent white collar workers and professionals. They seem destined to remain silent in the process of tax reform.

What is the future then for tax reform? It seems the present structure will not be radically altered. The political risk of attempting radical tax reform without wide agreement in the community and the difficulty of getting that agreement means change will be slow.

What is the future of an exercise like the Tax Summit? The grand notion of expecting honest, forthright and non-sectional opinions from interest groups seems misguided. Representatives choose to represent a certain group because they ably express the interests of its members in a society that deals out favours generally to those who exert the most pressure. These seem not to be the most suitable people to help with the task of transcending sectional interests to discern what is in the interests of the community as a whole. It would appear that the Government remains saddled with this responsibility.

AUSTRALIA:
Tax Reform

By D.C. Orrock

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On 4 June 1985 a Draft White Paper titled "Reform of the Australian Tax System" was released by the Australian Government and presented to a National Taxation Summit Conference held in Canberra during the first week of July, 1985. The Draft White Paper is a comprehensive document of some 280 pages and canvasses a wide range of issues.

The Draft White Paper indicated that a tax reform package including measures to reduce or eliminate concessions and avoidance could be formulated and effective in late 1985 or early 1986.

The National Taxation Summit of selected representatives of business, trade unions, commercial organisations and academia debated the Draft White Paper and was presided over by the Prime Minister and the Treasurer.

The Government put forward the following three alternative options:

1. Option A aimed at broadening the income tax base and included the following measures:
   - capital gains tax;
   - taxation of fringe benefits levied upon the employer;
   - non-deductibility of entertainment expenses;
   - a foreign tax credit system;
   - quarantining of losses arising from negatively geared property investments and farming activities;
   - elimination or reduction of nominated business tax concessions;
   - introduction of a national identification system to assist in reducing tax evasion;
   - minor personal income tax cuts.
2. Option B included all of the measures contained in Option A plus a broadly based consumption tax at a rate of 5%; the abolition of the existing wholesale sales tax (other than a 10% wholesale sales tax on motor cars, wine, soft drinks, etc.) and personal income tax cuts.
3. Option C consisted of the measures contained in Option B with the following changes:
   - the broadly based consumption tax would be set at a rate of 12.5%;
   - complete abolition of the existing wholesale sales tax;
   - major personal income tax cuts.

Going into the Summit the Australian Government's preferred option was Option C. The trade unions and left wing elements of the Labor Party, however, made it clear that they were not prepared to accept a consumption tax. The Prime Minister and Treasurer were forced, in order to protect the prices-income accord, to opt for a variation of Option A. The Summit ended in virtual disarray and the Federal Cabinet appointed sub-committees to consider the remaining options with the aim of announcing policy directions in late September. The business community strongly criticised the Government's altered course.

Shortly after the Summit, the Treasurer announced measures, operating from 18 July 1985, aimed at disallowing tax deductions for interest on negatively geared properties; the introduction of depreciation at 4% p.a. on new investment properties; and the replacement (for 1985-86) of the concessional expenditure tax rebate with a limited medical expenses rebate.

"Negative gearing" occurs where interest on borrowings used to finance rental property investments exceeds net rental income (gross rentals less maintenance, repairs, management fees, etc.) from that property. The new measures permit tax deductions for interest expense only to the extent of net rental income. The "excess interest" (i.e. the portion not allowed as a deduction) will be carried forward and allowed as a deduction against future rental income or any capital profit on disposal of the property. The new measure applies only to contractual arrangements entered into from 18 July 1985. Existing investments (i.e. prior to 18 July 1985) will continue to obtain the tax benefit from negative gearing whereby the excess of interest over net rental income is set off against income from other activities. All "new" (i.e. rental property investments from 18 July 1985) will be aggregated in determining whether total interest exceeds total net rental therefrom and capital profit on sale thereof for the year of income. The excess interest on "new" rental property investments will not be available to off-set net income from "old", i.e. pre 18 July 1985 rental property investments.

Depreciation at a rate of 4% p.a. will be available for expenditure incurred from 18 July 1985 on the construction of new buildings or extensions, alterations and improvements to existing buildings. The depreciation deduction will not be included in calculating the net income from rental investments. Consequently the depreciation deduction can be set off against other income where the investment is negatively geared.

On 13 August 1985 the Federal Treasurer announced that the Summit compromise was "unworkable, impracticable and inconsistent with the basic objectives of tax reform" and abandoned the proposal to extend the wholesale sales tax and to introduce a selected services tax. Costs of collection, anomalies and consumer price index increases were offered as reasons for this change in policy.

The foreshadowed announcement of the Government's final changes to the Australian taxation system was made on 19 September 1985. The changes broadly reflect the measures contained in Option A in the Draft White Paper. The major reforms are:

- capital gains tax;
- taxation of non-cash fringe benefits provided to employees. The tax will be levied on the employer on the assessed value to the employee of the benefit;
- deductions will not be permitted for entertainment expenses incurred after 19 September 1985;
- employment-related expense claims will be subjected to substantiation rules;
- rationalisation of the wholesale sales tax structure;
- full imputation of company dividends distributed to resident individual shareholders and an increase in the company tax rate to 49%;
- replacement of the present double taxation relief arrangements with a general foreign tax credit system;
- limitation of deductions for losses from primary production to farm income and a specified amount of non-farm income;
- extension of company tax arrangements to public trusts which operate a trade or business;
- reduction of tax incentives for investment in Australian films;
- introduction of a national identification system for individuals and business entities;
- marginal tax rates for individuals are to be reduced, effective in two steps from 1 September 1986 and 1 July 1987. The maximum marginal rate for the year commencing 1 July 1987 will be 49%.

The measures are being introduced on a variety of dates. The revenue generated by the changes is to finance the tax rate cuts. The changes are claimed to have minimal impact on the consumer price index. The legislation covering these changes is not expected until early 1986.

Reaction to the changes is mixed. There has been initial enthusiasm for the tax rate changes despite the fact that their full benefit will not be realised until June 1988. By that date inflation would have eroded much of that benefit.

There will be shifts in the strategies of investors with an expected diversion of funds from interest bearing securities to the stock market because of the favourable treatment of dividends resulting from the imputation tax system. Property investments (farming and rental properties) should see a decline in investor activity. The upper end of the housing market is expected to flourish due to the exemption from capital gains tax. These shifts will have adverse effects on some industries and on the Government's Bond issues.

There will be increased costs to the business community in meeting the tax on "fringe benefits". This particular change may create some instability in the executive labour market.

Australia's double taxation agreements will need to be renegotiated to cater for the introduction of the foreign tax credit system.

Details of the main areas of change are summarised in the following paragraphs:

Capital gains tax

The proposed capital gains tax will:

- apply to assets acquired after 19 September 1985;
- apply to the realised gain calculated by indexing the cost base for movements in the rate of inflation.

The Consumer Price Index will be applied to convert nominal capital gains into real capital gains;

- include the real capital gains in the vendor's assessable income and tax it at the ordinary rates of personal or company income tax;
- set off realised nominal losses against realised capital gains in the year of sale or carry forward any unrecouped losses against gains realised in later years;
- treat the disposal of assets by gift as a realisation. The cost to the recipient will be deemed to be the fair market value of the assets;
- not apply following the death of an asset holder unless the assets are realised by the administrator of the deceased 's estate or by a beneficiary. Assets acquired by the deceased on or before 19 September 1985 will be deemed to have been acquired by the administrator or beneficiary at a value equal to the indexed cost to the deceased at the date of death;
- not apply to gains on disposal of the taxpayer's principal residence. The principal residence is the housing unit "ordinarily inhabited" by the taxpayer and must be owned by the taxpayer rather than by an associated family trust or private company. Where the property is used partly as a principal residence and partly for other purposes the values of each component are apportioned to determine the exempt portion of any gain;
- abolish, for assets acquired after 19 September 1985, section 25A which includes as assessable income, gains arising from the sale of property acquired for the purpose of profit-making by sale or from the carrying on or the carrying out of any profit-making undertaking or scheme;
- retain section 26AAA which includes, in assessable income, taxable gains on property disposed of within 12 months of acquisition;
- defer capital gains tax liability in the case of:
  - (a) compensation for compulsory acquisition of assets and stolen or destroyed property, providing the replacement assets are acquired within a stipulated period;
  - (b) asset ownership changes associated with certain types of business reorganisations.

Imputation system of company tax

A full imputation system, commencing in 1987-88, will apply to resident individual shareholders. In line with this proposal the company tax rate will be increased from 46% to 49% and the undistributed profits tax imposed on private companies will be removed.

In order to apply an imputation credit to a dividend a compensatory tax will be paid by the company at the rate of $49 for every $51 distributed to shareholders. The compensatory tax paid will be set against the tax assessed on the profits of the company to discharge a corresponding amount of that liability.

Resident individuals receiving dividends will be entitled to a tax credit equal to the compensatory tax in calculating the tax liability on the total of the dividends and the credit.

The tax credit will not be available to non-resident shareholders. The changes will require the renegotiation of double tax treaties.

The credit will not apply to dividends received by Australian shareholders from non-resident companies, even if they have Australian branches.

It is intended that the 49% company tax rate will first apply to company incomes of the year ended 30 June 1987 and the compensatory tax credits will first apply to dividends paid in the year ended 30 June 1988.

Example:

A dividend of $51 received by a resident individual shareholder on a 40% marginal tax rate will qualify for a credit as follows:

Dividend	$ 51
Assessable (dividend plus credit) ($51 + $49)	100
Tax on $100	$ 40
Less Credit	$ 49
Net Credit available for off-set against tax on other income	$ 9

Foreign tax credit system

Section 23(q) of the Act exempts from Australian tax income derived in a foreign country if it has been subject to tax in that country. This exemption is to be withdrawn from the commencement of the 1987-88 income year. Foreign source income derived by Australian resident individuals and companies will then be subject to Australian income tax and a credit will be granted for the foreign tax paid by the Australian resident. The credit will be limited to the amount of Australian income tax payable on the foreign source income.

Where an Australian company has maintained a shareholding of not less than 10%, for a period of at least 12 months, in a foreign company it will be allowed a credit for both withholding tax paid on dividends received therefrom and the underlying relevant foreign company tax.

Australian residents deriving foreign source salaries or wages, that are subject to tax at source, will continue to be exempt from Australian income tax. A full exemption will be granted where the individual derives the foreign source income for a continuous period of 12 months. The exemption will be apportioned where the period is from 3 to 12 months. The exempt salary or wages will be taken into account in determining the rate of tax applicable to other income so as not to reduce the tax payable on that other income.

Credits will be applied on a country by country basis.

Primary production (i.e. farming) losses

Commencing in the 1986-87 income year, deductions for losses incurred in primary production activities will not be available for off-set against non-farm income, except to the extent that such other income is the greater of:

i. $15,000 (to be indexed) with a dollar for dollar reduction for non-farm incomes between $15,000 and $30,000; and
ii. the aggregate of the previous 5 years of net farm income.

Any "excess primary production loss" can be carried forward indefinitely for deduction in subsequent years against farm income, qualifying levels of non-farm income and taxable capital gains on disposal of primary production property. These losses will be deductible in priority to losses carried forward under existing provisions.

Entertainment expenses

Deductions will not be allowed for entertainment expenses incurred after 19 September 1985. The measure will apply to business meals, drinks, cocktail parties, staff social functions and will include tickets or boxes for theatrical or sporting events. It also covers payment of hostess allowances to spouses of executives. Entertainment allowances received by employees will continue to form part of his or her assessable income but the employee will not be entitled to a deduction for entertainment expenses funded by the allowance.

Non-cash fringe benefits

The taxation of the assessable value of benefits provided to employees is to be imposed on the employer (as from 1 July 1986) and payable on a quarterly basis. The types of benefits which will be subject to the new tax include cars, low interest loans, free or subsidised residential accommodation, goods or services sold at a discount and expenses paid on behalf of an employee. The range of benefits and the particular valuation rules will be announced when the relevant legislation is enacted.

Deductions for employment-related expense claims by employees will be subject to substantiation requirements regarding the quantum, purpose and documentary evidence of the outgoings.

Personal income tax rates

The marginal income tax rates for resident individuals are to be progressively reduced. The maximum marginal rate is to be equated with the new company tax rate of 49%.

The proposed tax rate scales are:

			Proposed sca[illegible]s	
Income $ p.a.	Present scale marginal rate	Income $ p.a.	1.9.1986 Ma[illegible]	[illegible]7
0 - 4,595	0	0 - 5,100	0	[illegible]
4,595 - 12,500	25	5,101 - 12,600	24	[illegible]
12,501 - 19,500	30	12,601 - 19,500	29	[illegible]
19,501 - 28,000	46	19,501 - 28,000	43	40
28,001 - 35,000	48	28,001 - 35,000	46	40
35,000 and over	60	35,000 and over	55	49

The tax-free threshold (currently $4,595) will not be available in entirety to those taxpayers entering the full-time workforce for the first time or leaving Australia permanently. These taxpayers will receive the benefit of the threshold on a pro-rata basis.

Future developments

The tax reform saga is far from finished. Intensive lobbying on several fronts, e.g. fringe benefits and entertainment deductions, could yet see further changes to these measures. The date of introduction of the required amending legislation is not known and may not be until early 1986. The introduction of the proposed tax rate reductions is dependent upon the success of the measures aimed at existing deductions, concessions and tax minimisation practices.

Further, the Draft White Paper raised other matters which have not been included in these tax reform proposals. Those matters, e.g. the use of trusts to spread income amongst family members, could be the subject of future reform measures. The prospect of a wealth tax or death duties has been unequivocally ruled out by the Government.

As stated earlier, the absence of any indexation of the income tax rate scale means that, with inflation, the present rate scale reductions will have been eroded by their effective date in 1988. The Government will then be faced with precisely the same problem as confronts it today – an increasing body of the taxpayers being caught by the upper marginal rates. This is despite the maximum 49% rate. Once again the options, now put aside, of reduced public sector spending and/or introduction of a broadly based consumption tax will need to be considered.

A Crack in the Crack-down

Last year, in Revenue Rulings 84-152 and 84-153, both having retroactive effect, the IRS cracked down on tax treaty shopping. Tax treaty shopping occurs when a third party, not normally covered by a tax treaty, attains a benefit from a bilateral treaty concluded between the United States and a country, not the domicile of the shopper.

In Revenue Ruling 84-152 a Swiss corporation lent money to its Antilles subsidiary, which thereafter lent the money to its United States subsidiary. When the United States subsidiary began to make interest payments to the Netherlands Antilles finance subsidiary, it attempted to attain exemption from taxation under Article VIII(1) of the United States-Netherlands income tax treaty. The IRS ruled that the United States-Switzerland income tax treaty was applicable and the interest payments were subject to a 5% withholding tax.

Revenue Ruling 84-153 concerned a United States corporation receiving interest at its Netherlands Antilles subsidiary from its domestic subsidiary from money originally lent to foreign persons and then relent to the domestic subsidiary. The Service ruled that the interest payments were not exempt under the United States-Netherlands income tax treaty.

On 30 September 1985 the IRS issued a statement that limits the application of the above-stated rulings to interest payments made on debt instruments issued on or after 15 October 1984, the date that Rev. Rul. 84-152 and Rev. Ruling 84-153 were published in the Internal Revenue Bulletin, pursuant to a binding written agreement entered into prior to 15 October 1984. This is also applicable to debt obligations issued on the exercise of a warrant or the conversion of a convertible obligation if such warrant or convertible obligation was issued prior to 15 October 1984.

This will result in the immediate clearing of many agreements under scrutiny pursuant to the retroactive effect of the previous rulings. Parties having concluded agreements and obligations prior to 15 October 1984 can breathe a sigh of relief as they slip through this crack in the crack-down on tax treaty shopping.

POST-GRADUATE COURSE IN BUSINESS TAX LAW – MILAN

Specialized courses are again offered in business tax law at Bucconi University, Milan, from 18 November 1985 till 6 May 1986. The courses will provide a general introduction to tax law, a view of the various ways in which tax law can affect other fields of law, and the most interesting tax aspects of the corporate structure. Several seminars are planned to enhance the program and increase dialogue.

Upon succesfull completion of the course work and an examination, participants will receive a certificate of proficiency.

The program is taught in Italian in the evening, to be compatible with work schedules. The director is Professor Victor Uckmar, Professor of Law at the University of Genoa.

Further information is available from:
Paola Gherarducci
Università Bucconi
Istituto di Diritto "A. Sraffa"
Via Sarfatti
25 Milano
Italy
Tel.: 83 84 373

U.S.A.:

Unitary Tax and Sharing of Information

Treasury Department's Draft Unitary Tax Legislation with Technical Explanation

On 8 July 1985 the U.S. Treasury released its proposals in the form of legislative language and a technical explanation which would permit States which reject or do not apply worldwide unitary taxation to have access to information generally available only to the Federal Government. For this purpose multinational corporations falling within certain categories would be required to submit annual information returns which would show corporate income tax liability and the amount of income subject to tax in each State as well as the method used to allocate income in those States.

TECHNICAL EXPLANATION: IN GENERAL

The proposed legislation would implement the undertaking of the Department of the Treasury in the Final Report of the Worldwide Unitary Taxation Working Group (the "Working Group Report"). The Working Group Report contemplates that the Department of the Treasury will seek legislation requiring corporations to report certain information regarding their State tax liability to the Federal Government and establishing procedures for sharing that information with qualifying States. The purpose of the proposed reporting and information-sharing provisions (new section 6039A and amended section 6103(d), respectively) is to permit the States to improve their taxation of multinational corporations.

PROPOSED SECTION 6039A INTERNAL REVENUE CODE

Sec. 1. Subpart A of part III of subchapter A of Chapter 61 of the Internal Revenue Code of 1954 (relating to information returns) is amended by adding immediately after section 6039 the following section:

SECTION 6039A.:

Information with Respect to Certain Multistate and Multinational Corporations –

(a) General Rule – A reporting corporation shall file, within 90 days of the due date (including extensions thereof) of its Federal income tax return for the taxable year, a return disclosing information relating to its State income tax returns for State taxable years ending with or within the taxable year of such corporation for Federal income tax purposes. Such return shall include the reporting corporation's income tax liability to each State in which it is liable to pay income tax, its income subject to tax in each State, the method of calculation by which the reporting corporation computed and allocated its income subject to tax by each State, each corporation in which the reporting corporation, or any corporation owning 50% or more of the outstanding voting stock of the reporting corporation, owns, directly or indirectly, more than twenty percent of the combined voting power of all classes of stock entitled to vote, and such other related information as the Secretary may by regulation prescribe.

(b) Reporting by Related Corporations –

(1) Reporting by Common Parent of Affiliated Group – If a reporting corporation is a common parent of an affiliated group of corporations, it shall file a return disclosing the information described in subsection (a) with respect to each includible corporation in such affiliated group. Such information shall be filed for the State taxable year of each includible corporation ending with or within the common parent corporation's taxable year for Federal income tax purposes.

(2) Reporting by Other Related Corporations – If a reporting corporation is a member of a controlled group of corporations that includes a foreign corporation that is described in section 6103(d)(4)(G) but is not required to file a Federal income tax return, then such reporting corporation shall, in filing the return required by this section, include the information that such foreign corporation would be required to file under this section if it were a reporting corporation. This paragraph shall not apply if such reporting corporation and such foreign corporation are included in a return described in paragraph (1).

(c) Definitions –

(1) Reporting Corporations –

(A) In general. For purposes of this section, the term "reporting corporation" means a corporation that is required to file a Federal income tax return for the taxable year, and that

(i) makes aggregate payments of at least $ 1,000,000 as compensation for services rendered in any single foreign country during the taxable years;
(ii) owns assets situated in any single foreign country with an aggregate fair market value of at least $ 1,000,000 as of the close of the taxable year;
(iii) has gross sales occurring in any single foreign country of at least $ 1,000,000 during the taxable year; or
(iv) owns assets with an aggregate fair market value, as of the close of the taxable year, of at least $ 250,000,000.

The Secretary shall have authority at any time to increase by regulation any dollar threshold set forth in this paragraph. The allocation of compensation payments, property or sales to or among foreign countries shall be determined under regulations prescribed by the Secretary.

(B) Application of definition to Related Corporations. For purposes of applying subparagraph (a) to related corporations –

(i) compensation paid by, property owned by, or sales made by members of an affiliated group of corporations shall be treated as if paid, owned, or made directly by the common parent corporation; and
(ii) compensation paid by, property owned by, or sales made by members of a controlled group of corporations that are not members of the same affiliated group of corporations shall be consolidated and attributed to each member of such controlled group that is required to file a Federal income tax return.

(2) Affiliated Group – For purposes of this section, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is required to file a Federal income tax return for the taxable year if

(i) stock possessing more then 50% of the combined voting power of all classes of stock entitled to vote of each of the includible corporations (except the common parent corporation) is owned directly or indirectly by one or more of the other includible corporations within the affiliated group; and
(ii) the common parent corporation owns directly stock possessing more than 50% of the voting power of all classes of stock entitled to vote of at least one of the other includible corporations.

(3) Includible Corporation – For purposes of this section, with respect to any taxable year, the term "includible corporation" means (i) any domestic corporation, other than a corporation exempt from tax under section 501, (ii) any corporation incorporated in the Commonwealth of Puerto Rico, Guam, American Samoa or the United States Virgin Islands, (iii) any corporation defined in section 922, (iv) any foreign corporation that is required to file a Federal income tax return with respect to such taxable year, or (v) any other foreign corporation that is described in section 6103(d)(4)(G).

(4) Controlled Group – For purposes of this section, the term "controlled group" has the meaning given to such term by section 267(f)(1), except that the determination shall be made without regard to section 1563(b)(2)(C).

(d) Status of Return – If the information return filed pursuant to subsection (a), or any information reflected on such return, is disclosed or made available to a State tax agency (as defined in section 6103(d)(4)(C)), or to any common or designated agency (as defined in section 6103(d)(4)(A) and (B) in which a State participates, the return may thereupon be treated, if and to the extent provided by the laws of such State, as if originally filed with such State for purposes of the imposition of civil or criminal penalties under the laws of such State for negligence, fraud, or a material understatement of income or of tax liability.

(e) Dollar Penalty for Failure to Comply –

(1) In general – If with respect to any taxable year a reporting corporation fails to comply substantially with the requirement of subsection (a), such corporation shall pay a penalty of $ 1,000.

(2) Increase in penalty where failure continues after notification – If any failure described in paragraph (1) continues for more than 90 days after the date on which the Secretary mails notice of such failure to the reporting corporation, such corporation shall pay a penalty (in addition to the penalty imposed by paragraph (1)) of $ 1,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of such 90-day period. The increase in penalty under this paragraph shall not exceed $ 24,000.

(3) Penalties in addition to any penalty that may be imposed under State law – Nothing in this subsection shall preclude any State from imposing any fines or penalties for negligence, fraud, or understatement of income or of tax liability in accordance with the laws of that State.

TECHNICAL EXPLANATION TO PROPOSED SECTION 6039A

A. Section 6039A

1. *In general.* New section 6039A would require that a "reporting corporation" file an information return with the Internal Revenue Service. The information return would include the reporting corporation's income tax liability in each State, the amount of its income subject to tax in each State, and the method of calculation by which it computed its income subject to tax in each State (e.g., the amount of property, payroll and sales allocated to each State and the allocation factors used in computing those amounts). It is contemplated that these items would be contained in a domestic disclosure spreadsheet developed by the Treasury in accordance with the Working Group Report. In addition to the spreadsheet information, a reporting corporation would be required to disclose the name of each corporation in which it or any corporation owning 50% or more of its voting stock owns a 20% or greater interest and any other information required to be reported under regulations promulgated by the Secretary.

2. *Definition of reporting corporation.* A corporation would not be required to file a section 6039A return unless it is a "reporting corporation" for the taxable year. In general, a corporation would be a "reporting corporation" if it is required to file a Federal income tax return for the year and satisfies any one of four business activity thresholds: (i) $ 1,000,000 in annual payments for compensation in a single foreign country; (ii) $ 1,000,000 in assets in a single foreign country; (iii) annual gross sales of $ 1,000,000 in a single foreign country; or (iv) total worldwide assets of $ 250,000, without regard to location. The principles for applying these tests would be developed under regulations; it is anticipated that in the case of tests (i) - (iii) these regulations would utilize the measurement and sourcing rules used for State tax purposes in the Uniform Division of Income for Tax Purposes Act.

A corporation required to file a Federal income tax return would not be able to utilize subsidiaries to avoid the requirements of section 6039A. Thus, in the case of an affiliated group of corporations with a common parent corporation, the numerical thresholds would be applied on a consolidated basis by attributing payments of compensation, ownership of property, or sales made by subsidiaries directly to the common parent. This attribution rule would apply to all subsidiary corporations that are within the same controlled group of corporations (within the meaning of section 267(f)(1)), provided the comon parent corporation is required to file a Federal income tax return for the year.

To prevent circumvention of the numerical thresholds of section 6039A by brother-sister corporations, similar rules would apply in cases where the common parent is not required to file a Federal income tax return. These aggregation rules would apply to the extent that 50% or more of the stock of each such corporation is owned, directly or indirectly, by the same person. In such a case, the corporations' property, payroll, and sales would be aggregated and attributed to each such corporation required to file a Federal income tax return for purposes of determining its status as a "reporting corporation" under section 6039A.

3. *Filing by affiliated groups.* Section 6039A(b) would require that any reporting corporation that is also the common parent of an affiliated group of corporations file the section 6039A return on behalf of all includible corporations in its affiliated group. In addition, the common parent corporation would be required to aggregate the property, payroll, and sales of the other includible corporations in the affiliated group in determining whether the threshold requirements for classification as a reporting corporation are met.

For purposes of section 6039A, an "affiliated group" would consist of a chain of "includible corporations" connected through voting stock ownership of at least 50% with a common parent corporation that is required to file a Federal income tax return for the year (and subject to reporting under section 6039A either directly or through attribution from its subsidiaries). Thus, a foreign corporation not engaged in a U.S. trade or business generally could not be the common parent of an affiliated group for purposes of section 6039A. Each reporting corporation would be included in only one affiliated group, either as the common parent or as a subsidiary; a first-tier subsidiary of one affiliated group would not be treated as a common parent with respect to the second- and third-tier subsidiaries for purposes of the section 6039A return requirements.

A corporation would be defined as an "includible corporation", and therefore included within an affiliated group, if it is (i) a domestic corporation that is not exempt under IRC § 501; (ii) a corporation incorporated in the Commonwealth of Puerto Rico, Guam, American Samoa, or the United States Virgin Islands; (iii) a foreign sales corporation within the meaning of IRC § 922; (iv) any foreign corporation required to file a Federal income tax return with respect to the taxable year; or (v) any other foreign corporation that is not otherwise required to file a Federal income tax return if it carries on no substantial economic activity or if 50% or more of its sales are made to one or more members of the same affiliated group, or if 50% of its expenses (computed without regard to payments for intangible property) or 80% of all its expenses are incurred with respect to products or services acquired from one or more members of the same affiliated group. A foreign corporation would not be classified as an includible corporation under clause (v) (proposed sections 6039A(c)(3)(v) and 6103(d)(4)(G)) unless, under standards established in regulations to be prescribed by the Secretary, it is not subject to substantial foreign tax on its net income. Under these definitions a foreign corporation engaged in a U.S. trade or business could constitute a reporting corporation, in which case it would be required to file a section 6039A return with respect to its U.S. subsidiaries, its foreign subsidiaries otherwise required to file a Federal income tax return, and any of its foreign subsidiaries falling within the definition of "includible corporation" by reason of section 6039A(c)(3)(v). It would not be required to report with respect to its other non-U.S. subsidiaries, although it would be required to disclose the existence of such subsidiaries.

4. *Additional requirements for related corporations.* In addition to the requirements that apply for corporations within one affiliated group, section 6039A would require that a reporting corporation related to a foreign corporation described in section 6039A(c)(3)(v) and 6103(d)(4)(G)) include information pertaining to such foreign corporation on its section 6039A return. The information to be included would be the information that the foreign corporation would be required to file if it were a reporting corporation. Thus, if a reporting corporation has substantial dealings with a related foreign corporation that is not otherwise required to file a Federal income tax return but is described in section 6103(d)(4)(G), the reporting corporation's section 6039A return would include the spreadsheet information on the related foreign corporation (assuming the two corporations are not members of a larger "affiliated group" for

purposes of section 6039A). This requirement would not apply if the foreign corporation is required to file a Federal income tax return; in that case, the attribution of property, payroll, and sales between related corporations would ensure that the foreign corporation would constitute a reporting corporation in its own right, and it would be directly responsible for filing its own section 6039A return.

For purposes of this requirement, two corporations would be treated as owned by the same person if they are connected through ownership of 50% or more of their outstanding voting stock by the same person, whether directly or indirectly.

5. *Filing Deadlines.* A reporting corporation's section 6039A return would be due 90 days from the due date (including extensions) of its Federal income tax return. The information included on a reporting corporation's section 6039A return generally would deal with the corporation's Federal taxable year. In the unusual situation where the taxpayer's State and Federal taxable years are different, the section 6039A return would cover State taxable years ending within the taxpayer's Federal taxable year. If a reporting corporation is required to include on its section 6039A return State tax information pertaining to related corporations, such information would be required for the taxable years of the related corporations that end with or within the reporting corporation's taxable year. The section 6039A return filed by a reporting corporation on behalf of a related foreign corporation not otherwise required to file a Federal income tax return would reflect information for the foreign corporation for the year ending with the reporting corporation's taxable year or for the calendar year ending within the reporting corporation's taxable year.

6. Penalties. Section 6039A(e) imposes penalties for failure to substantially comply with the reporting obligation. As suggested by the Working Group Report, these penalties are identical to those currently imposed in connection with the information reporting required by section 6038, and are in addition to any fines or penalties that may be imposed under State law. Moreover, if a section 6039A return is disclosed to a State the State may treat the return as originally filed with it for purposes of imposing any such State fines or penalties.

PROPOSED AMENDMENTS TO SECTION 6103 INTERNAL REVENUE CODE

Sec. 2. Section 6103 of the Internal Revenue Code of 1954 (relating to confidentiality and disclosure of returns and return information) is amended by –

(a) revising subsection (d) to read as follows:

(d) *Disclosure to State Officials, Etc.*

(1) In general – Upon compliance with the procedures and requirements of paragraph 2, returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 34, 44, 45, 51, and 52 and subchapter D of chapter 36, returns described in section 6039A, and return information obtained by the Internal Revenue Service from any foreign government, or agency or department thereof, under the exchange of information provisions of any income tax treaty, estate and gift tax treaty or agreement described in section 274(h)(6)(C), to which the United States is a party, shall be open to inspection by, or disclosure to, any State tax agency for the purposes of, and only to the extent necessary in, the administration of the tax laws of a State, including any procedures with respect to locating any person who may be entitled to a refund. Notwithstanding the preceding sentence:

(A) return information obtained under treaties or section 274(h)(6)(C) agreements shall be open to examination or disclosure only to the extent such examination or disclosure is permitted by, and shall be subject to any limitation imposed by, the relevant treaty or agreement; and

(B) neither section 6039A returns nor return information obtained under a treaty or section 274(h)(6)(C) agreement shall be disclosed to a State tax agency if

(i) the State is not a qualified State within the meaning of section (d)(4)(e); or

(ii) any taxpayer included in the section 6039A return, or any taxpayer to which the return information relates, files, or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis in that State.

Returns and return information described in this paragraph (1) relating to any taxpayer that is reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation shall also be open to inspection by or disclosure to any common agency or the designated agency.

(2) Procedures and restrictions –

(A) Persons to whom information may be disclosed – Except as the Secretary shall prescribe by regulation, inspection shall be permitted, or disclosure made, under paragraph (1) only upon written request by the head of the State tax agency, common or designated agency, and only to the representatives of such agency designated in such written request as the individuals who are to inspect or to receive the returns or return information on behalf of such agency. Such representatives shall not include any individual who is the chief executive officer of a State or who is neither an employee or legal representative of such agency nor a person described in subsection (n). Returns and return information shall not be disclosed under paragraph (1) to the extent that the Secretary determines that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

(B) Disclosure of returns and return information relating to section 6039A reporting corporations by State tax agencies, common and designated agencies – A State tax agency, common agency or designated agency obtaining returns or return information that are described in paragraph (1) and relate to any taxpayer that a is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation, may disclose such returns and return information to a State tax agency of any other State, provided:

(i) the State to which the information is to be disclosed is a qualified State;

(ii) no taxpayer to which the return information relates, including each taxpayer included on a section 6039A return, files or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis is that other State; and

(iii) the State tax agency of such other State has entered into an applicable nondisclosure agreement with the Secretary that satisfies the requirement of paragraph (2)(C).

(C) Nondisclosure agreement – A State tax agency, common agency or designated agency obtaining returns or return information that are described in paragraph (1) and relate to any taxpayer that is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation shall be required to execute a nondisclosure agreement with the Secretary prohibiting the disclosure of such returns or return information or of any data, information or conclusion extracted from or based upon such returns or return information, to any State tax agency if

(i) the State is not a qualified State within the meaning of section (d)(4)(E), or

(ii) any taxpayer to which the return information relates, including each taxpayer included on a section 6039A return, files, or is part of a related group of corporations that files, State tax returns on a world wide unitary basis in that State.

The agreement shall also prohibit any State tax agency obtaining such returns or return information from using the returns or return information in connection with its examination of any taxpayer which files on a worldwide unitary basis in that State. The required nondisclosure agreement shall contain such additional terms and conditions as the Secretary shall prescribe.

(D) Use of information obtained by State tax agencies – A State shall not use any section 6039A return or any return information obtained under a treaty or section 274(h)(6)(C) agreement in connection with its examination of any taxpayer that files on a worldwide unitary basis in that State.

(3) Disclosure to State audit agencies – Returns or return information described in paragraph (1) obtained by any State tax agency may be open to inspection by, or disclosure to, officers and employees of a State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State tax agency. Notwithstanding the

preceding sentence, return information obtained under a treaty or section 274(h)(6)(C) agreement shall not be open to inspection by or disclosure to any State audit agency.

(4) Definitions –

(A) Common agency – For purposes of this section, the term "common agency" means a joint or common agency, body, or commission which has been designated under the laws of four or more qualified States to represent such States collectively in the administration of the corporate income tax laws of those States and which has executed a nondisclosure agreement of the type described in paragraph (d)(2)(C).

(B) Designated agency – For purposes of this section, the term "designated agency" means that agency which has been or may be designated under the laws of a plurality of all qualified States, to obtain from the Internal Revenue Service and process on behalf of such State returns and related return information, including returns described in section 6039A, and which has executed a nondisclosure agreement of the type described in paragraph (d)(2)(C).

(C) State tax agency – For purposes of this section, the term "State tax agency" means any agency, body, commission or other body charged under the laws of a State with responsibility for the administration of State tax laws.

(D) State audit agency – For purposes of this section, the term "State audit agency" means any State agency, body, commission, or entity which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

(E) Qualified State – For purposes of this section, the term "qualified State" means a State that the Secretary determines does not require taxpayers to compute tax on a worldwide unitary basis, except where:

(i) a company fails to comply with the requirements of section 6039A or with the legal and procedural requirements of the income tax laws of such State;

(ii) neither the taxpayer nor the government of the relevant foreign country provides to the State, within a reasonable period after proper request, information sufficient to determine the arm's-length nature of transactions between any corporation described in section (d)(4)(F) and any other foreign corporation which is a member of the same controlled group of corporations (within the meaning of section 6039A(c)(4)); or

(iii) separate accounting, after necessary and appropriate adjustments, fails to prevent the evasion of taxes or clearly reflect income.

A determination by the Secretary under this paragraph shall be conclusive and not subject to review by any court.

(F) Worldwide Unitary Basis – For purposes of this section, the term "worldwide unitary basis" means that in computing state income tax a corporation or related group corporations includes or is required to include in the income base on which the tax is calculated an allocated share of the income of corporations other than:

(i) domestic corporations more than 50% of the voting stock of which is owned directly or indirectly by a corporation that is a member of the affiliated group;

(ii) domestic corporations that have made an effective election under section 936;

(iii) corporations defined in section 922;

(iv) corporations organized in the commonwealth of Puerto Rico, Guam, American Samoa or the United States Virgin Islands;

(v) foreign corporations if (I) such corporation is subject to state income tax in at least one state by virtue of its business activities in that State; and (II) such corporation has (a) at least $ 10,000,000 in compensation payments for services rendered, sales or purchases during its most recent Federal taxable year or property with a fair market value of at least $ 10,000,000 as of the last day of its most recent Federal taxable year, assignable to one or more locations in the United States, or (b) the average of the percentages of such corporation's property (valued as of the last day of its most recent Federal taxable year), compensation payments for personal services (determined for its most recent Federal taxable year), and sales (determined for its most recent Federal taxable year) that is assignable to one or more locations in the United States is at least 20%;

(vi) foreign corporations described in section (d)(4)(G).

(G) Certain foreign corporations – A foreign corporation is described in this subparagraph if such corporation –

(i) is a member of a controlled group of corporations (within the meaning of section 6039A(c)(4)) that includes at least one reporting corporation (within the meaning of section 6039A) that is not described in this subparagraph (G);

(ii) either carries on no substantial economic activity or makes at least

  (a) 50% of its sales,

  (b) 50% of its payments for expenses other than payments for intangible property, or

  (c) 80% of all of its payments for expenses,

to one or more corporations that are described in clauses (i) through (v) of subparagraph (F) and that are within the controlled group of corporations referred to in clause (i) of this subparagraph; and

(iii) under standards, established in regulations to be prescribed by the Secretary, is not subject to substantial foreign tax on its net income.

(b) Striking "subsection (e)(1)(D)(iii)" in subsection (a)(3) and inserting in lieu thereof "paragraph (1) of subsection (d), subsection (e)(1)(D)(iii)".

Sec. 3. The second sentence of section 274(h)(6)(C)(i) of the Internal Revenue Code of 1954 (relating to exchange of information agreements) is amended to provide as follows:

Except as provided in clause (ii), an exchange of information agreement shall provide for the exchange of such information (not limited to information concerning nationals or residents of the United States or the beneficiary country) as may be necessary and appropriate to carry out and enforce the tax laws of the United States, the tax laws of beneficiary country (whether criminal or civil proceedings) and if the parties to the agreement agree, the tax laws of the several States of the United States, including information which may otherwise be subject to nondisclosure provisions of the local law of the beneficiary country (such as provisions respecting bank secrecy and bearer shares).

Sec. 4. Effective Date. The amendments made by section 1, section 2 and section 3 shall be effective for taxable years beginning after 31 December 1985.

TECHNICAL EXPLANATION TO AMENDED SECTION 6103 OF THE INTERNAL REVENUE CODE

B. Section 6103(d)

The second portion of the proposed legislation would amend section 6103(d) of the Code to provide new rules regarding the access of States to taxpayer information collected by and in the possession of the Internal Revenue Service. Although the legislation's primary purpose is to make available to States the information returns required by section 6039A, it also controls the availability to States of other taxpayer return information with respect to section 6039A reporting corporations gathered or generated by the Service, including information received under exchange-of-information agreements with other countries.

1. *State access to return information.* The proposed legislation would amend section 6103(d)(1) by adding the section 6039A information return to the return information to which States are permitted access. State access to section 6039A information returns would be subject to four significant qualifications. First, State access to a section 6039A information return would be subject to the same restrictions applicable under present section 6103 to the disclosure of Federal income tax returns to State governments. Second, section 6039A returns would not be disclosed to any State that is not a "qualified State". Third, a section 6039A return would not be disclosed to a State if the reporting corporation filing such return, or any other affiliated corporation included on such return, computes its income tax liability on a worldwide unitary basis in such State. Fourth, a section 6039A return would not be disclosed to a State unless the State has executed a nondisclosure agreement with the Department of the Treasury. In general, this agreement would permit information sharing between States,

but it would prohibit disclosure of the section 6039A return to any state that would not otherwise be eligible to receive such information under the requirements contained in this paragraph. This agreement would also prohibit use of a section 6039A return to audit any unrelated taxpayer that computes its income tax liability on a worldwide unitary basis in the State receiving such return.

With respect to Federal income tax returns and other information to which the States already have access under section 6103(d), the legislation would amend current law to permit the sharing of such information between States. Such information sharing would be permitted only with respect to corporations that are "reporting corporations" within the meaning of section 6039A. Moreover, a State would not be permitted to share such information with another State unless such other State is a qualified State and the taxpayer to which such information relates does not compute its income tax liability in such State on a worldwide unitary basis.

2. *State access to treaty information.* Section 6103(d)(1) also permits States to obtain access to returns and return information obtained by the Secretary under treaty exchange-of-information provisions. Treaty information would be disclosed to a State only to the extent permitted by the relevant treaty and would be subject to any limitations imposed by such treaty. In addition, disclosure of such information would be subject to the same restrictions and limitations applicable to the disclosure of section 6039A returns. Thus, if a corporation computes its State income tax liability on a worldwide unitary basis in a State, such State would not be entitled to receive any treaty-derived information with respect to such corporation.

3. *Definition of qualified State.* A State is not entitled to receive section 6039A return information or treaty information unless it is a "qualified State". Section 6103(d) would define a qualified State as any State that does not require taxpayers to compute State income tax liability on a worldwide unitary basis. Qualified States could require worldwide unitary apportionment under three limited circumstances. First, worldwide unitary apportionment could be required if the taxpayer materially fails to comply with the requirements of section 6039A and applicable State law. Incidental procedural failures by a taxpayer, standing alone, would not justify imposition of worldwide unitary apportionment. Second, worldwide unitary apportionment could be required by a qualified State if the State is unable to obtain the records necessary to audit the taxpayer's State tax returns.

This would occur only if (i) the taxpayer refuses to provide information regarding transactions between members of its water's edge group and related companies outside the water's edge group, and (ii) treaty exchange-of-information procedures are not available to the State through the Internal Revenue Service. Third, a qualified State could require worldwide unitary apportionment if the State determines, after necessary and appropriate adjustments, that separate accounting by the taxpayer and its affiliates fails to clearly reflect income or to prevent the evasion or avoidance of taxes. It is expected that separate accounting will yield appropriate results in virtually all cases.

4. *Definition of worldwide unitary basis.* As discussed above, a State will not meet the definition of a qualified States unless its use of the worldwide unitary method of taxation is limited to specified circumstances. Moreover, even if the State is a qualified State, its access to section 6039A return information and treaty-derived information is limited to those taxpayers that do not compute their State income tax liability on a worldwide unitary basis in that State.

For purposes of these rules, the term "worldwide unitary basis" would be defined by section 6103(d)(4)(F) in a manner consistent with the water's edge limitation contained in the Working Group Report. In general, a corporation will be considered as being taxed on a worldwide unitary basis if, in computing income subject to tax, it includes an allocated share of the income of corporations other than the following enumerated corporations: (i) domestic corporations more than 50% of the voting stock of which is owned, directly or indirectly, by a member of the affiliated group; (ii) domestic corporations eligible for the possessions tax credit under section 936; (iii) foreign sales corporations (FSC) within the meaning of section 922; (iv) corporations organized in the Commonwealth of Puerto Rico, Guam, American Samoa, or the United States Virgin Islands; or (v) foreign corporations described in section 6103(d)(4)(F)(v) or (G).

Under section 6103(d)(4)(F)(v), a State could include a foreign corporation in a unitary group without violating the worldwide unitary prohibition if the foreign corporation has at least $ 10,000,000 in compensation payments for services rendered, sales, or purchases during its most recent Federal taxable year, or property with a fair market value of at least $ 10,000,000 as of the last day of its most recent Federal taxable year, assignable to one or more locations in the United States, or if the average of the percentages of the corporation's property, compensation payments, and sales that are assignable to one or more locations in the United States is at least 20%. In either of these cases, inclusion of the foreign corporation in a water's edge unitary group is permissible only if the foreign corporation is subject to income tax in at least one State by virtue of its business activities in that State.

Section 6103(d)(4)(G) would permit the inclusion of a foreign corporation within a water's edge group if it is a member of a controlled group of corporations that includes at least one reporting corporation and if it has no substantial economic activity or has the requisite degree of economic dealings with other members of the water's edge unitary group. A foreign corporation otherwise subject to inclusion in the water's edge group under these rules would be excluded from such group if, under standards to be established in regulations to be prescribed by the Secretary, it is subject to substantial foreign tax on its net income. Although the Working Group Report suggested that the determination of whether the corporation pays substantial foreign tax would be based on the nominal foreign tax rate, the Treasury Department does not believe that such a formulation is adequate and would expect to base required regulations on factors in addition to the applicable nominal foreign tax rate.

The proposed legislation takes no position on whether a so-called 80/20 corporation (defined in the Working Group Report as a U.S. corporation which has no more than 20% of its property or payroll attributable to sources within the United States) could be included in a water's edge group. Such corporations would be within the statutory definitions of "reporting corporation" and "includible corporation" in section 6039A, however, and the inclusion of such corporations in a unitary combination would not violate section 6103(d)'s restrictions against use of the worldwide unitary method. These provisions should not be viewed as an endorsement by the Treasury of the inclusion of such corporations in a unitary group.

In addition, the proposed legislation remains neutral on the question whether dividends received from a foreign corporation that is not a member of a permitted water's edge unitary group may be taxed to the recipient as part of its water's edge unitary group income. Again, the fact that the inclusion of such dividends in a group's consolidated income does not violate the restriction on the use of the worldwide unitary method should not be viewed as indicating that the Treasury believes the taxation of such dividends is appropriate.

5. *Common agencies; designated agency.* Any information with respect to a section 6039A reporting corporation that may be disclosed to a State under section 6103(d) may also be disclosed to a common agency or to the designated agency. A common agency is an agency designated by four or more qualified states to assist in the administration of the income tax laws of such States. At any given time, the designated agency is the agency designated by a plurality of the qualified States to assist in the administration of the income tax laws of such States. Only one designated agency will be recognized by the Federal government at any given time.

A common agency or the designated agency may obtain the section 6103(d) information only upon the execution of the nondisclosure agreement that qualified States are required to execute in order to obtain such information. Thus, a common agency that obtains a section 6039A return or other Federal income tax return or treaty information would be precluded from making any such return or information available to any State if such State is not a qualified State or if any corporation covered by such return or information files, or is part of a group of related corporations that file, an income tax return on a worldwide unitary basis in such State.

The prohibition against disclosure would apply to any information made available to the common or designated agency pursuant to section 6103(d). Thus, a common agency receiving a copy of a taxpayer's Federal income tax return would not be permitted to make available any information reflected on such return to any State unless such State is a qualified State and the taxpayer does not compute its income tax liability on a unitary basis in such State. Moreover, a common or designated agency would not be permitted to make recommendations or suggestions regarding audits of taxpayers to any State tax agency based upon returns or return information in the common or designated agency's possession unless the State is a qualified State and the taxpayer does not compute its State income tax liability on a worldwide unitary basis in such State.

U.S.A.:

Tax Haven Audit Guidelines

The Internal Revenue Manual 4233.550 of 11 March 1985 contains audit guidelines for tax havens issued to Revenue agents. The text is reproduced below:

TAX HAVEN DEFINED

Tax havens are commonly thought of as locations outside the United States that provide a favorable tax climate for American taxpayers. The audit guidelines are more specific in that they state that a tax haven has one or more of the following characteristics:

(1) it imposes little or no tax on a transaction compared to the tax imposed on such transaction by developed countries;
(2) it provides confidentiality of financial and commercial information;
(3) it has modern communications facilities; and
(4) it has a treaty network that offers reduced tax rates on income taxable by its treaty partners.

The guidelines do not specifically mention any countries as being havens, but they do note that Ireland and Singapore have offered tax holidays to corporations that set up manufacturing operations using local labor and exporting the manufactured goods. Elsewhere in the Internal Revenue Manual, the following 30 jurisdictions are listed as tax havens, but it is made clear that the list is not exclusive: Antigua, Austria, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Costa Rica, Channel Islands, Gibraltar, Grenada, Hong Kong, Ireland, Isle of Man, Liberia, Lichtenstein, Luxembourg, Monaco, Nauru, the Netherlands, the Netherlands Antilles, Vanuatu (formerly New Hebrides), Panama, Singapore, St. Kitts, St. Vincent, Switzerland, and Turks and Caicos Islands.[1]

POTENTIAL ISSUES

Among the situations that the guidelines instruct the examiner to be alert for are:

(1) an outbound transfer of intangibles (e.g., trademarks, customer lists) as to which a non-tax avoidance ruling[2] should have been requested;
(2) a license agreement and its royalty rate (if the rate is not an arm's-length rate, the IRS is empowered to allocate income to the entities that earn it); and
(3) "wholly autonomous" manufacturers (if a manufacturer is not "wholly autonomous," it may not be justifiable in lodging all income from manufacturing, intangibles, and marketing in tax haven jurisdictions).

AUDIT GUIDELINES

As soon as the examiner becomes aware that a U.S. taxpayer has transactions with a foreign entity located in a tax haven area, the taxpayer is to examine the transaction for business and tax motives.

If U.S. real property was purchased from a foreign entity, the examiner is to determine whether that entity is related directly or through some scheme whereby the basis of the property may have been artificially increased. He is to review the terms of the sale, including interest rates charged, payments on principal, and how funds are transferred. If the foreign entity sold this property, the Foreign Investment in Real Property Tax Act of 1980 also may come into play.

If the tax haven entity has large salary, rent, and similar expenses on its profit statement, it must be determined (1) if such expenses were allocated from a related U.S. entity or (2) if they were charged to the tax haven by an unrelated bank, insurance company, law firm or other service company, which could indicate that the tax haven is not a viable entity. If a foreign bank was used, the agent is to determine whether it is a viable bank or just one in name only that shares desk space with other banks.

MULTIPLE TRUST

The guidelines also describe a tax haven scheme that involves the use of multiple trusts. For instance, a taxpayer with a going business causes a trust (first trust) created by a resident in a tax haven. The creator appoints the taxpayer as trustee. The first trust then forms two or more trusts in another tax haven that has secrecy laws and is designated trustee. The second trust acts as management consultant to the U.S. taxpayer. The consulting fee virtually eliminates the profits of the U.S. business. The second trust files Form 1040NR because the fee is considered U.S.-source income, but the income is reduced or eliminated by the payment of a "contingent royalty fee" to the third trust. The latter ends up with the profits originated by the going business, which are then returned to the taxpayer by the third trust either in the form of gifts or loans.

The IRS views the foreign trust problem as "essentially an auditing problem". A review of business expenses by an IRS agent should uncover deductions for contingent royalty fees or management consulting fees.

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[1] Internal Revenue Manual 4233, Ex. 500-13.

[2] Code Sec. 367.

EUROPEAN COMMUNITIES:

Income Taxation and Equal Treatment for Men and Women

Contents

Report drawn up on behalf of the Committee on Women's Rights concerning the Memorandum presented by the EC Commission to the EC Council (COM (84) 695 final – Doc. 2-1759/84) on income taxation and equal treatment for men and women. The report reproduced here was submitted by Dame Shelagh Roberts on 28 May 1985 to the European Parliament ((PE 95.817/fin.) published in Doc. A2-55/85 of 6 June 1985). For the EC Commission Report, see the June 1985 issue of this *Bulletin* at 262, the article by Norma Briggs, "Individual income taxation and social benefits in Sweden, the United Kingdom and the U.S.A. – A study of their inter-relationships and their effects on lower-income couples and single heads of household", in the same issue (at 243), and in the July 1985 issue (at 301) the article by Prof. Sylvian R.F. Plasschaert, "The treatment of spouses' incomes in schedular and global models of income taxation".

By letter of 9 January 1985, the Commission of the European Communities requested the European Parliament to deliver an opinion on the memorandum from the Commission of the European Communities to the Council on income taxation and equal treatment for men and women.

On 11 March 1985, the President of the European Parliament referred this memorandum to the Committee on Women's Rights as the committee responsible and the Committee on Economic and Monetary Affairs and Industrial Policy and the Committee on Social Affairs and Employment for an opinion.

At its meeting on 26 February 1985, the Committee on Women's Rights appointed Dame Shelagh Roberts rapporteur.

The Committee considered the Commission's memorandum and the draft report at its meetings of 23/24 April 1985 and 21/22 May 1985.

At the latter meeting the committee adopted the motion for a resolution as a whole by 9 votes to 0 with 2 abstentions.

The following took part in the vote:
Mmes. Lenz (Chairman), Cinciari Rodano and Giannakou-Koutsikou (Vice-Chairmen), Dame Shelagh Roberts (rapporteur), D'Ancona (deputising for Mrs. Van den Heuvel), Braun-Moser, Brookes (deputising for Mr. Pearce), Mr. de Camaret (deputising for Mrs. Lehideux), Mmes. Daly, Heinrich and Maij-Weggen.

☆☆☆

The opinions of the Committee on Economic and Monetary Affairs and Industrial Policy, and the Committee on Social Affairs and Employment are attached.

The report was tabled on 28 May 1985.

The deadline for tabling amendments to this report will be indicated in the draft agenda for the part-session at which it will debated.

A. MOTION FOR A RESOLUTION

The Committee on Women's Rights hereby submits to the European Parliament the following motion for a resolution, together with explanatory statement, embodying the opinion of the European Parliament on the memorandum presented by the Commission to the Council on income taxation and equal treatment for men and women.

The European Parliament,

- having regard to the Commission memorandum (COM (84) 695 final),
- having been asked for its opinion by the Commission (Doc. 2-1759/84),
- having regard to its resolution of 11 February 1981 on the position of women in the European Community,[1] notably the second indent of paragraph 2(a) thereof,
- having regard to its resolution of 17 January 1984 on the situation of women in Europe,[2] notably paragraph 20 thereof,
- having regard to its opinion[3] on the Council directive on the principle of equal treatment for men and women in self-employed occupations, including agriculture, and on protection during pregnancy and maternity, and most notably its proposed amendment to Article 6 thereof,
- having regard to the report of the Committee on Women's Rights and the opinions of the Committee on Economic and Monetary Affairs and Industrial Policy, and the Committee on Social Affairs and Employment (Doc. A 2-55/85),

(a) whereas, in Action 6 of the "Action Programme of the promotion of equal opportunities for Women", the Commission proposed to undertake a comparative analysis of taxation systems, with a view to taking appropriate measures should this analysis show that the systems in effect in certain Member States have any negative effect, even indirectly, on equal opportunities for women,

(b) bearing in mind the Council resolution of 12 July 1982 on the promotion of equal opportunities for women[4] which approved the general objectives of the Commission's Action Programme,

(c) noting that Community action with a view to ensuring the implementation of the principle of equal treatment between men and women in fiscal legislation can only result from measures to be proposed by the Commission, no such measures being contained in the memorandum under consideration,

(d) whereas the failure by governments of varying political philosophies to eradicate discrimination against married women in fiscal legislation has a profound psychological effect on many women who thereby have a distorted appreciation of their earning capacity and a resulting deep sense of injustice,

(e) whereas, in the majority of cases, married couples who are assessed jointly (simple aggregation of both incomes, the splitting system and the family quotient system) have to pay more than if they were assessed separately.

1. Takes note of the Commission's memorandum on income taxation and equal treatment for men and women, and fervently echoes the wish therein expressed that it may stimulate debate at Community level on the impact of income taxation sys-

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[1] Official Journal of the European Communities (OJ) C 50, 9.3.1981.
[2] OJ C 46, 20.2.1984.
[3] OJ C 172, 2.7.1984.
[4] OJ C 186, 21.7.1982.

tems on equal treatment of men and women in the labour market;

2. Notes that national income taxation systems have been shown in many instances to have an adverse effect, albeit sometimes indirect, on women's employment in that the impact of fiscal legislation can cause married women to hesitate to take up salaried employment, and may result in active discouragement by husbands of spouses desirous of entering the labour market;

3. Notes that not only are women restricted in their activity by arrangements under the national systems of taxation, but that married women are at a disadvantage compared with unmarried women when paying tax and that this may deter women from getting married;

4. Considers that such a state of affairs can be seen as an obstacle to the implementation of the principle of equal pay between men and women doing the same work or work of equal value (since, while references are made to equal gross pay, there are no references to equal net pay for equal work, thus violating Article 1(1) of Directive 75/117/EEC[5]), and could thereby be considered as direct or indirect salary discrimination;

5. Considers also that such a state of affairs can only be seen as an obstacle to equal access to employment and promotion for married women, and as such does not allow them full enjoyment of equal treatment as defined by Directive 76/207/EEC[6];

6. Considers that the provisions of the existing directives have proved inadquate to ensure equal treatment in fiscal matters, in that discrimination is seen to subsist in certain cases; calls on the Commission to clearly define the concept of indirect discrimination and in the light of that definition to examine fiscal legislation with particular references to possible violation of the equal treatment directives with a view to instituting proceedings against those countries whose fiscal legislation deters women from pursuing their right to equal access to employment or promotion;

7. Recalls its twice stated[7] request for a directive on equal treatment for men and women in fiscal legislation, with a view to complementing directives 75/117/EEC and 76/207/EEC and stongly reiterates this request;

8. Considers it desirable that such a directive should establish the following principles:

- the Member States should organize their income taxation systems to avoid any form of direct or indirect discrimination against women by reference to their sex, marital status or family situation;
- the Member States should organize their income taxation systems to avoid any direct or indirect fiscal pressures (via the husband) which deter women from working;
- in their income taxation systems the Member States should opt for individual assessment of each taxpayer;
- allowances and reductions should relate to the income of the person who has actually incurred the expenditure;
  if expenditure eligible for tax allowances or reductions is borne by both partners, the allowances should be distributed proportionally between the two partners;
- the costs of child care and domestic help incurred to enable a job to be held, must be tax-deductible;
- flat rate allowances relating to household expenditure should be shared on a proportional basis between the two partners;
- special taxation concessions for men whose wives work exclusively in the home should be replaced by a parental or care allowance paid directly to the parent responsible;
  this allowance should be linked to the rules applicable to "parental or family leave";
- spouses working in family businesses should be entitled to a fair share of the income and equal and separate treatment with regard to taxation.

9. Consequently, regrets that the Commission has seen fit to content itself with a memorandum, rather than proposing action by the Community, and urges that current discussions should be conducted with a view to the preparation of a draft directive on which work should start immediately;

10. Notes that it is clear from
(a) the Commission's study of the income taxation systems in force in the Member States (V/2798/1/82), and
(b) the inquiry carried out by the Committee of Inquiry into the Situation of Women in Europe (Topic 15, Doc. 1-1229/83/C) that equal treatment of men and women requires separate taxation of men and women, and that the tax system "be neutral as between the married couple where only one partner is in paid employment and the married couple where both partners are in paid employment with a mandatory system of independent taxation for husband and wife as the long-term objective if fiscal reform" (Para. 20(b)(ii) of resolution of 17 January 1984);

11. Strongly urges the governments of the Member States to take account of these recommendations in reforming their fiscal legislation, and welcomes, in this connection, the recent British government promise to produce later this year a Green Paper to propose, inter alia, the separate taxation of husbands and wives;

12. Instructs its President to forward this resolution to the Council and Commission, and to the governments of the Member States.

B. EXPLANATORY STATEMENT

Background

1. In its resolution of 11 February 1981,[8] the European Parliament called for "a directive on equal treatment for male and female workers in the Members States' fiscal legislation, taking into account the relationship between family income and the number of dependants". This was seen to be a necessary adjunct to the directive on equal pay.[9]

2. In December 1981, the Commission presented its "Action Programme on the promotion of equal opportunities for Women",[10] and, in Action 6, proposed to undertake a comparative analysis of taxation systems, with a view to taking appropriate measures should this analysis show that the systems in effect in certain Member States have any negative effect, even indirectly, on equal opportunities for women.

The Commission proposal resulted in a major study on the "implementation of equal treatment by revising income tax systems which appear to have an indirect adverse effect on women's employment, their right to work and their promotion in employment" (V/2798/1/82).

This study considered, in great detail, the income taxation systems in force in the Member States. Its conclusions with regard to each country were as follows:

Belgium
Marriage is always penalised, and it is not always the couples with the highest income who experience the greatest increases, especially where there are dependent children (op. cit., p. 20).

Denmark
If the income of one spouse is negative, the loss can be set off against the positive income of the other.

The tax exemption of a man or wife whose spouse has no taxable income is twice that of a single taxpayer or of each spouse in a couple with two taxable incomes.

If both spouses have incomes, it is possible to transfer the unused part of this exemption to the other spouse (op. cit., p. 26, 27).

Germany
The splitting-system favours the married and especially spouses whose incomes are of very different levels. In case of splitting, the losses caused by one of the spouses are deductible from the revenue of the other.

Under the separate taxation system, the married couple is treated less favourably than two single people as far as extraordinary expenses are concerned (op. cit., p. 38, 39).

Greece
Spouses must return their income together. If both spouses run a partnership together, their total income is taxed in the man's name. The wife's contribution to her husband's business is not recognised.

Discrimination exists in that the allowances and tax reductions are automatically given in the man's name, whereas the wife has to request this explicitly (op. cit., p. 49, 50).

France
The conjugal quotient reinforces the notion of [the wife's earnings being a] supplemen-

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[5] OJ L 45, 19.2.1975.
[6] OJ L 39, 14.2.1976.
[7] Resolution of 11.2.1981: OJ C 50, 9.3.1981, and Resolution of 17.1.1984: OJ C 46, 20.2.1984.
[8] OJ C 50, 9.3.1981.
[9] Directive 75/117/EEC; OJ L 45, 19.2.1975.
[10] Doc. 1-927/81 (COM(81) 758 final).

tary income. The second income (which is usually the women's) is taxed at the marginal rate reached by the first and therefore almost wholly supports the effects of the graduated scale.

The tax saving due to the conjugal quotient is highest for a couple with one income. This may be an incentive for keeping the wife in the home and therefore goes against the independence induced by her working outside the home.

The higher the wife's income and the higher her contribution to the couple's total income, the more she is penalised by the tax system (op. cit., p. 60, 61).

Ireland
Single persons are at a disadvantage relative to married couples. Like all splitting systems, the system gives a substantial tax advantage to the husband whose wife does not work outside the home. A married woman who does work outside the home is therefore at a disadvantage in relation to wives who stay at home (op. cit., p. 70).

Italy
The Italian tax system does not contain any discrimination against women in salaried employment. [The only criticism which can be levelled against the Italian system is, however,] the lack of any allowance or tax-credit for child-care expenses (op. cit., p. 78).

Luxembourg
The system is only neutral in the case where the incomes of the couple are equal and where there are children (op. cit., p. 100).

Netherlands
The exempted minimum [the tax-free allowance of a married man is spectacularly higher than that available to a married woman] and the separate taxation of only her professional income form the principal sources of distortion (op. cit., p. 114).

United Kingdom
Except in the case of separate assessment (an option which is taken up by only 3% of those to whom it is available) the husband is regarded as being the only one capable of handling the couple's tax questions, and the wife becomes "invisible" in the eyes of the tax authorities. She has to advise her spouse of her income, so that he may complete their joint tax return, whereas the husband may keep details of his earnings to himself.

The husband enjoys a married man's allowance which is granted solely by reason of the marriage and does not cover any specific needs.

Generally speaking, the principle of aggregate taxation may be criticised for the following two reasons:

- the wife's income is taxed at the maximum rate applicable to her husband's income;
- the couple reaches the maximum tax rate sooner (op. cit., p. 128).

A further criticism of the system is that a husband and wife who are both earning receive a higher allowance than a couple where only the husband is earning.

3. The topic of "Taxation: Special Problems encountered by Women" was retained by the Committee of Inquiry into the Situation of Women in Europe among its eighteen topics of inquiry (Topic 15, Doc. 1-1229/83/C).

TABLE I

Country	*Assessment unit*	*Assessment based on*	*Remarks*
Belgium	Family	Cumulation	Joint assessment general rule
Denmark	Individual		Tax is calculated on aggregate income – total tax levied is *not* influenced by capital distribution between spouses
Germany	Family	Splitting	"Splitting" can discourage married women from entering employment as higher tax would be levied on couple's aggregate income
Greece	Individual		Joint declaration of incomes in husband's name
France	Family	Family quotient	Joint management by couples of family income – both spouses must sign tax declaration return
Ireland	Family	Splitting	Separate treatment generally less favourable to married couples than joint or separate assessment
Italy	Individual		System of equal and independent treatment of women as taxable persons
Luxembourg	Family	Family quotient	Couple jointly taxed as single unit
Netherlands	Individual		Joint assessment: married men have higher tax-free allowance, married women lower
United Kingdom	Family	Cumulation	Joint assessment general rule. A two-earner couple receive a higher total of allowances than either a one-earner couple or two single people

Your rapporteur had the honour of drafting that report for that Committee. The principal conclusions reached in this report, whose scope was necessarily less exhaustive than the Commission study referred to above, were essentially the same as those reached in that study.

The main features of taxation systems in the Members States were seen to be as in Table I.

It was seen that the areas where discrimination may be discerned were the following:

(i) The women's income is often treated as belonging to her husband. Thus the woman often has no separate existence as a "taxable person". It is quite possible that, in many cases, a married women is completely ignorant of household income and declaration for tax purposes;

(ii) The married woman has no privacy in respect of her own income;

(iii) The woman is not entrusted with the handling of her own tax affairs;

(iv) Tax deductions are often set against the husband's income and not the wife's which means that, where income tax is withheld at source by the employer, the wife will have vis à vis her husband, a proportionally greater amount of tax withheld.

Whereas the notion of the husband as "head of household", being the provider and thus responsible for the financial support of the family, may have reflected social reality in the past, it no longer corresponds to the modern woman's conception of her role in society.

A woman in salaried employment is entitled to the responsibility of managing her own income.

Equally, there is no reason why a woman who chooses to devote herself full-time to the management of her home and the rearing of her children should thereby become a second-class citizen from an economic viewpoint. Consideration of the aggregate incomes of the child nurse, housekeeper and cook whom she replaces would rapidly establish the value of her contribution to society!

Consequent to these conclusions, the following recommendations were made:

(a) The tax system should be neutral as between the married couple where only one partner is in paid employment and the married couple where both partners are in paid employment.

(b) The long-term objective of fiscal reform should be a mandatory system of independent taxation for husband and wife.

(c) In the case of harmonisation of national legislation in regard to taxation, the choice of the individual as the tax unit, with appropriate allocation of allowances, is preferable to that of the family or household.

(d) If the tax authorities persist in treating the family as the tax unit, married couples where only one partner is in salaried employment should be able to make the tax deductions of two single taxable persons.

4. In its resolution of 17 January 1984,[11] the European Parliament welcomed "the Commission's proposal to undertake a comparative analysis on taxation systems", and called on the Commission, "in its analysis and in the measures to be proposed, to take into account:

(i) the conclusions and recommendations set out in the report of the Committee of Inquiry into the Situation of Women in Europe concerning the special problems encountered by women with regard to taxation, and,

(~~iii~~) in particular, that the tax system should be neutral as between the married couple where only one partner is in paid employment and the married couple where both partners are in paid employment, with a mandatory system of independent taxation for husband and wife as the long-term objective of fiscal reform". [paragraph 20]

It also reiterated the call for "directive on equal treatment for men and women in fiscal legislation".

Commission Memorandum

1. The European Parliament's resolution of 17 January 1984[12] also called on the Council "to adopt the appropriate measures [to implement the principle of equal treatment by revising income tax systems which appear to have an indirect adverse effect on womens employment, their right to work and their promotion in employment] . . . on the basis of the proposals to be submitted to it by the Commission".

2. In its resolution of 12 July 1982[13] on the promotion of equal opportunities for women, the Council had approved the general objectives of the "Action Programme on the promotion of equal opportunities for women" which included the implementation of the principle of equal treatment in income taxation.

The Council thereby may be understood to have expressed its intention to take the necessary measures to achieve equal treatment men and women in the area of fiscal legislation. The Council will only take such action if appropriate proposals are submitted to it by the Commission.

It is therefore disappointing to see that the Commission memorandum under consideration contains no proposals.

3. According to the Commission press release when the memorandum was drafted: "The aim of the Memorandum is essentially to provide the elements for a discussion of this problem at Community level, in describing the existing systems and in drawing out the problems relating to equal treatment in the different elements that make up the systems of income taxation". Given the scope and detail of the report into the different national taxation systems drawn up for the Commission, it must be the subject of some regret that the Commission is now merely presenting to the Council a memorandum with a view to the "discussion of this problem at Community level".

4. While we may understand the reason for the Commission's caution, and while we may be aware of the difficulties of drafting proposals in this area which will be acceptable to all parties, the Commission's sense of political reality cannot but seem a feeble excuse for this lack of boldness of approach. The Commission's recent survey into "European Women in Paid Employment 1984" (V/1240(84)) reveals the following finding with regard to income taxation: "one married working woman out of five thinks that the tax system is such that it could discourage women from working because the extra tax on the household would take up nearly all their earnings" (p. 18). The prevalence of the feeling that the wife's earnings are responsible for pushing a couple's income into a higher bracket and that it is *her* income which goes to pay the higher tax bill must be seen as a positive disincentive to married women to take up employment, at least in some countries.

Indeed, cases have been noted of pressure being brought to bear by husbands in order to dissuade their wives from taking up salaried employment, for this very reason.

This is surely enough to show that the taxation systems in effect in certain Member States have a negative effect, albeit indirectly, on equal opportunities for these women.

Legal context

1. National sentivities are sure to run very high faced with talk of "harmonisation of legislation" in this area which is certainly of national competence.

2. The first two Council Directives aim at equal treatment of men and women in the field of employment: that they should receive equal pay for equal work, and that they should enjoy equal access to employment. It is obvious that a married woman will hesitate to take up salaried employment if this will result in a disproportionate additional tax burden for the family. Where such constraint exists, she cannot be said to have equal access to employment and promotion. There is no doubt that the underlying philosophy behind the directives on equal pay[14] and equal treatment in working conditions[15] would require full implementation of the principle of equal treatment in this touchy area of fiscal legislation. The amount of a woman's earnings which "go to the taxman" certainly affect her take-home pay and, more insidiously and perhaps ultimately more importantly, her perception and her husband's of her earning capacity.

3. The Council adopted on 13 December 1984, a recommendation[16] on the promotion of positive action for women. Such an instrument has no binding force.

The rationale that was used to justify a recommendation as opposed to any other Community instrument in this area, was the absence of legislation in many Member States for the promotion of positive action.

Fiscal legislation most definitely exists in all Member States. The indirect effect of many of the systems in force tends in some cases to discourage women from taking up salaried employment. The laws are there; therefore this is undoubtedly an area where "harmonisation of legislation" can be called for.

Conclusion

Basic logic imposes the reiteration of the European Parliament's twice stated call[17] for "a directive on equal treatment for men and women in fiscal legislation", such a directive to be based on the neutrality of the tax system as between the married couple where only one partner is in paid employment and the married couple where both partners are in paid employment, with a mandatory system of independent taxation for husband and wife as the long-term objective of fiscal reform (see paragraph 20 of resolution of 17.1.1984).

OPINION

(Rule 101 of the Rules of Procedure)

of the Committee on Economic and Monetary Affairs and Industrial Policy
Draftsman: Mrs. Marijke van Hemeldonck.

On 26 March 1985, the Committee on Economic and Monetary Affairs and Industrial Policy appointed Mrs. Marijke van Hemeldonck draftsman.

It discussed the draft opinion at its meeting on 23 April 1985 and at the same meeting adopted the conclusions thereof by 17 votes with 1 abstention.

The following took part in the vote: Mr. Seal, chairman; Mr. Beazley, vice-chairman; Mrs. van Hemeldonck, draftsman; Mr. Besse, Mr. Beumer, Mr. Bonaccini, Mr. Cassidy, Mr. Christodoulou (deputizing for Mr. Ercini); Mrs. De March, Mr. de Vries, Mr. Falconer, Mr. Filinis, Mr. Gautier, Mr. Metten, Mrs. Oppenheim, Mrs. van Rooy (deputizing for Mr. Harmen); Mr. Wedekind and Mr. von Wogau.

1. Introduction

This memorandum forms, part of the further implementation of the social policy of the European Community,[18] more specifically, equal treatment for men and women. Progress has been made on incorporating this principle into Community law, particularly since the 1970s, as a result of three Directives[19] and significant case law established by the Court of Justice.[20]

Despite some progress in a number of areas towards implementing the principle of equal treatment, both *de jure* and *de facto* discrimination is still rife. In a resolution of 11 February 1981,[21] the European Parlia-

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[11] OJ C 46, 20.2.1984.
[12] OJ C 46, 20.2.1984.
[13] OJ C 186, 21.7.1982.
[14] Directive 75/117/EEC; OJ 45, 19.2.1975.
[15] Directive 76/207/EEC; OJ L 39, 14.2.1976.
[16] OJ L 331, 19.12.1984.
[17] Resolutions of 11.2.1981 and 17.1.1984.
[18] Part 3, Title III of the EEC Treaty.
[19] 76/207/EEC of 9 February 1976, 79/7/EEC of 19 December 1978 and 75/117/EEC of 10 February 1975.
[20] In particular, the three judgments in the Defrenne v. Sabena case, the "stewardess cases".
[21] OJ No. C 50, 9.3.1981.

ment drew attention to the discrimination arising under several Member States' fiscal legislations from the aggregation of the incomes of a married couple in a system of progressive tax rates. It has subsequently called several times for a directive on harmonization to be drawn up.[22] The memorandum under consideration, which analyses the situation in the various Member States, is the Commissions response.

2. Position of the Committee on Economic and Monetary Affairs and Industrial Policy

The analysis clearly shows that the effect of aggregate taxation of the income of a married couple, even where modified by a splitting system, is to create discrimination against working married women. The memorandum thus confirms the critical views previously expressed by the European Parliament's Committee of Inquiry into the Situation of Women in Europe.

This committee would, however, also draw attention to two further matters falling within its terms of reference which make harmonization desirable:

1. free movement of persons and services. Taxation systems in the EEC range from full aggregation through splitting to the separate taxation of the incomes of married couples. Married persons, whether employees or self-employed, will thus receive a greater or lesser net income depending on the Member State in which they work. This may affect the free movement of persons and services;

2. harmonisation of taxation as part of the common market. In order to pay the same net earnings to employees in different Member States, undertakings have to provide much higher gross pay in a Member State where aggregation is in force than in a Member State where married couples are subject to separate taxation. It is obvious that this may influence undertakings in their choice of locations and thus adversely affect the functioning of the common market (cf. Article 100 of the EEC Treaty).

The analysis also shows that there is already a high degree of standardization between Member States with regard to the tax allowances and reductions payable which are closely connected with the aggregate system. A number of major divergences remain, however, (see p. 17 of the memorandum) such as the possibility of deducting the costs of child-care. It therefore seems appropriate to combine in a single directive measures to harmonize the system of both separate taxation and tax allowances.

3. Conclusions

The Committee on Economic and Monetary Affairs and Industrial Policy:

- agrees with the conclusion of the Commission's analysis that the present situation denies women equal opportunity;
- believes that Community measures are necessary from the point of view of both tax harmonisation and of the free movement of persons and services;
- believes that aggregation or separate taxation should be a matter of choice for the individual;
- urges the Commission to submit a proposal for a directive laying down rules for the introduction of separate taxation and the further harmonization of tax allowances and reductions.

OPINION

(Rule 101 of the Rules of Procedure)

of the Committee on Social Affairs and Employment

Draftsman: Mrs. Maij-Weggen

On 18 December 1984, the Committee on Social Affairs and Employment appointed Mrs. Maij-Weggen draftsman of its opinion.

The Committee considered the draft opinion at its meeting of 22/23 April 1985 and, at the latter meeting, adopted its conclusions by 19 votes in favour with 2 abstentions.

The following took part in the vote: Mr. Welsh, chairman; Mrs. Salisch, vice-chairman; Mr. Alavanos, vice-chairman; Mrs. Maij-Weggen, draftsman; Mr. Avgerinos (deputizing for Mrs. d'Ancona), Mr. Bachy, Mr. Christiansen, Mrs. Dury, Mrs. Gadioux (deputizing for Mr. Dido'), Mrs. Giannakou-Koutsikou, Mrs. Larive-Groendendaal, Mrs. Marinaro (deputizing for Mr. Raggio), Mr. Megahy, Mr. Pininfarina, Mr. Pordea (deputizng for Mr. Le Chevallier), Mr. Sakellariou (deputizing for Mr. Stewart), Mrs. Squarcialupi (deputizing for Mrs. Hoffmann), Sir Jack Stewart-Clark, Mr. Tuckman, Mr. Vgenopoulos and Mr. Wawrzik (deputizing for Mr. Brok).

1. Background to the memorandum

On 11 February 1981 the European Parliament adopted a report and resolution drawn up by what was then the Ad Hoc Committee on Women's Rights on the position of women in the European Community (Doc. 1-829/80, 29.1.1981). This report contained a large number of recommendations calling on the Community to promote the equal treatment of men and women. One of these recommendations referred to the equal treatment of women in tax legislation. The report by the Ad Hoc Committee on Women's Rights had found that the tax legislation in the Member States often discriminated directly or indirectly against women.

The Commission reacted favourably to Parliament's report and resolution and in December 1981 published an "action programme on the promotion of equal opportunities for women". This action programme contained 16 points, which followed up the recommendations set out in Parliament's resolution.

The sixth point of this action programme focused on the position of women in tax legislation. The Commission proposed carrying out a study into possible discriminatory aspects of national tax legislation and gave an assurance that, if necessary, it would take measures to remove any discrimination.

The action programme was adopted by the Council on 12 July 1982.

The Commission subsequently completed its promised study into the position of women in tax legislation.[23] The Committee of Inquiry into the situation of women in Europe set up by the European Parliament in 1981 also conducted a study into the position of women in tax legislation.[24] Both studies confirm the surmise, already expressed in Parliament's report of February 1981 that discrimination is indeed practised.

In the light of these two studies and of the undertaking contained in the action programme, the Commission has now submitted to the Council and Parliament a memorandum on income taxation and equal treatment for men and women. The Commission's aim with this memorandum is to initiate discussion on this subject in the Council and Parliament with a view to establishing what measures are politically desirable and feasible.

2. Summary of memorandum

The memorandum once again summarizes briefly the most significant causes of unequal treatment as revealed by the above studies. The following points are covered:

2.1 Tax unit

The Member States apply overall systems based on the tax unit: separate taxation whereby each individual, irrespective of his or her marital status, receives an individual tax assessment and aggregate taxation whereby married couples receive a joint assessment.

The Member States apply three variations of aggregate taxation: simple addition of the two incomes, a system of splitting and a family quotient system. Some Member States allow combinations of separate and aggregate taxation or a choice between the two systems.

The study shows that the systems of aggregate taxation are the primary cause of unequal treatment. This applies above all to the system of simple addition but, to a lesser extent, also to the splitting system and the family quotient system.

In the first case, the wife's income is taxed more heavily than that of the husband by virtue of the progressive tax rates that apply

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[22] Cf. the memorandum, pp. 1-2.

[23] Implementation of equal treatment by revising income tax systems which appear to have an indirect adverse effect on women's employment, their right to work and their promotion in employment. Doc. V/2798/1/82-EN/FR/ by Meulders/Haustraete/Six/Vanden Abeele.

[24] Topic No. 15 of the report by the Committee of Inquiry into the situation of women in Europe on "taxation: special problems encountered by women", co-rapporteur: Dame Shelagh Roberts (Doc. 1-1229/83, 5.1.1984).

in all Member States. In the other two cases the higher rate of taxation is split between the married couple, sometimes and sometimes not taking account of the number of children, so that the greater burden is distributed proportionately. Taken together, however, the married couple still generally pays more than if separate taxation were levied.

2.2 Tax rates

All Member States apply different rates of tax to different levels of income, with rates increasing in proportion to the level of earnings. This system of tax progression does not have a discriminatory effect in the case of separate taxation but, in the case of simple addition of incomes, is very disadvantageous for the second family income. This disadvantage an be partially offset by the splitting system and the family quotient system.

2.3 Tax allowances and reductions

The Member States apply a wide variety of tax allowances and reductions.

In the case of separate taxation, allowances/reductions are sometimes granted to the person who has actually incurred the costs in question. In most cases, however, allowances/reductions are applied to the highest income (often the husband).

In the case of aggregate taxation, allowances are virtually always applied to the joint income. It is remarkable that obvious costs that have to be met by the wife in order for her to work away from home (child-minding, housekeeping) are often not deductible. Many tax allowances seem to be tailored more to the working life of the man rather than that of the woman.

N.B. A point that is not included in the memorandum but which is worth mentioning is that many Member States grant special allowances and/or reductions for sole breadwinners (mostly the husband). Although such arrangements are entirely acceptable, they can greatly influence the spouse's decision to join the labour market. This is particularly the case when the sole earner loses such allowances as soon as his wife goes out to work. If the loss in question is relatively large and the wife's potential earnings are relatively low, the wife will often decline to seek paid employment, whether or not under pressure from her spouse.

2.4 Tax returns

In the case of separate taxation the married couple receives separate tax forms which must also be signed separately by the husband and wife.

The situation is more complicated in the case of aggregate taxation. Sometimes the married man and wife are each required separately to file the same tax return, sometimes the husband is responsible for completing the tax return but his wife must also sign it, sometimes the tax returns must be completed and signed jointly by the married couple and sometimes the husband alone files a joint return, which the wife is not required to sign.

2.5 Women and self-employed occupations

The position of the assisting spouse in the family firm calls once again for special attention.

In most Member States a system of proportional income allocation applies to this group, which is then subject to the application of the system of separate or aggregate taxation.

Some Member States, however, fix a ceiling on the amount that may be allocated by way of income to the assisting spouse. One Member State even applies a system of separate taxation for ordinary workers but an aggregate system based on simple addition of income for assisting spouses. It is self-evident that both the fixing of a ceiling and inequality of treatment in relation to other married couples is not acceptable and gives rise to unequal treatment.

3. Summary

It is clear from the contents of the memorandum that there are a fairly large number of situations in which women are treated unequally in terms of taxation or in which women otherwise encounter difficulties on account of the taxation system.

To sum up, the points at issue are as follows:

- the system of aggregate taxation results, in the case of simple addition of earnings, in a level of taxation on the income of the married woman which is higher than the level of taxation on a comparable income of a married man or of an unmarried man or woman. This results in a lower net remuneration for the married woman and may result in her withdrawing from the labour market after marriage;
- the same effects can be forthcoming, albeit to a lesser extent, where the splitting or family quotent systems are used;
- as the progression of tax rates becomes more onerous, the adverse affects on women will increase where the system of aggregate taxation is used;
- in some Member States where the system of aggregate taxation is used the woman does not receive her own notice of assessment; sometimes she is required to co-sign the joint tax return and sometimes even this is not required. In most Member States, however, the marriage partner is jointly responsible for any non-payment of taxes by the spouse;
- where tax allowances or reductons are granted within a marriage solely to the husband or the person with the highest income (in other words mostly the husband), this also results in unequal treatment of the married woman vis-à-vis the married man and the unmarried man and woman in the form of an adverse affect on the net earnings of the married woman;
- where the working wife is not entitled to claim tax allowances for child-minding and assistance with housekeeping, this will involve her in considerable extra expenditure and hence represent an additional burden on her net income. If her level of her earnings cannot cope with these extra items, she will often have to choose between the double burden of paid employment and work in the home and partial or total abandonment of paid employment;
- setting a ceiling on the amount of income allocated to an assisting spouse can represent a far-reaching degree of unequal treatment. The same applies to the aggregation of the earnings of the self-employed husband and his assisting wife for the purposes of taxation;
- special tax arrangements for sole breadwinners in the form of higher reductions or allowances are both understandable and dangerous, because the loss of these advantages once the spouse is earning an income of her own may prompt the wife to give up the idea of paid employment and will certainly do so where the potential earnings are small.

Conclusions

1. The conclusions set out in the Commission morandum tally to a significant extent with the conclusions already drawn in 1981 and 1984 by Parliament in the Maij-Weggen resolution on the position of women in the European Community (Doc. 1-829/80) and in the Roberts report of enquiry on "taxation: special problems encountered by women" (Doc. 1-1229/83).

2. It is therefore to be regretted that, on this issue, the Commission has confined itself to presenting a memorandum which in fact simply reiterates all the problems in question and has not submitted a directive such as could eliminate the unequal treatment of women in the matter of tax legislation.

3. The Commission should therefore be asked to replace the memorandum with a directive on the equal treatment of men and women in the matter of taxation legislation incorporating the following points:

- the Member States should design their systems of wage and income taxation in such a way as to avoid any form of direct or indirect discrimination against women with reference to sex, marital status or family situation;
- the Member States should design their systems of wage and income taxation in such a way as to avoid any form of fiscal pressure, whether a direct or indirect (from the spouse), that prompts women to abandon the idea of engaging in paid employment;
- the Member States should, in their wage and income tax systems, opt for an individual approach for each taxable person;
- tax allowances and reductions should be offset against the income of the person who has actually incurred the costs in question. Where certain items of expenditure that are eligible to be offset against tax in the form of a tax allowance or reduction are borne by both partners, the relevant allowances and reductions should be divided proportionally between the two of them;

- it should be possible to deduct from wage and income tax the costs of child-minding and housekeeping assistance that are incurred in order to make it possible to go out to work;
- fixed allowances relating to family responsibilities should be divided proportionally between the two partners;
- special tax arrangements for sole breadwinners should be replaced by a parental allowance or a dependent person's allowance to be paid directly to the parent actually responsible. These allowances should be linked to rules governing parental leave or family leave;
- assisting spouses in family businesses should be entitled to a proportional share of income and proportional and independent treatment in the matter of income taxation.

INCOME TAXATION AND EQUAL TREATMENT FOR MEN AND WOMEN

Opinion of the Economic and Social Committee of the European Communities concerning the Memorandum on Income Taxation and Equal Treatment for Men and Women published by the EC Commission[1]

On 3 January 1985 the Commission of the European Communities decided to consult the Economic and Social Committee concerning its Memorandum on income taxation and equal treatment for men and women. At its plenary session of 4 July 1985 the Economic and Social Committee adopted the following Opinion:[2]

1. The Economic and Social Committee welcomes the fact that the Commission has taken action to examine, in respect of wage and salary incomes, the direct and indirect effects of the income tax systems on equality of opportunity for men and women.

2. Ideas concerning the roles of men and women in society have undergone a radical change in recent decades. Whereas previously the husband was regarded as head of the household with responsibility for supporting the family financially, it is now more and more the case that men and women share financial and other responsibilities in the family. This means that men and women must have equal opportunities above all as regards employment. It must therefore be ensured that they have equal access to employment, receive the same wages for the same work and have the same tax and social insurance liabilities.

3. The Commission has already issued Directives dealing with the first two subjects at Community level. In the present Memorandum, the Commission turns to the question of the equal treatment of men and women as regards income tax. On the basis of a detailed comparative analysis the Commission comes to the conclusion that there is direct and/or indirect discrimination, albeit of very different kinds, in the income tax systems of all the Member States. It also emerges that the tax laws often embody a "moral" evaluation of family or martial status which can vary greatly from one country to another. In the Federal Republic of Germany, for instance, married couples are better off than single persons as a result of the splitting system applied there, whereas in Belgium married couples are still at a disadvantage if both partners are gainfully employed, because they are taxed jointly and so pay more tax, since they come into a higher band in the progressive scale.

4. In the Committee's view, tax laws should on no account incorporate an evaluation of the status of being married or not. Tax systems should be completely neutral in this respect. Taxation should be based to a greater extent on the personal ability to pay.

5. The Committee agrees with the Commission that discrimination against the second income earner, generally the wife, can be precluded only by separate taxation of spouses' incomes. The Committee regrets that this correct conclusion drawn from the analysis is not presented convincingly in the Commission's Memorandum.

6. The Committee would urge the Commission to extend its comparative analysis to cover all types of income. The Commission should also examine and indicate in greater detail which family or marital status is discriminated against in the various Member States and what form this discrimination takes. On the basis of this analysis a Directive on the equal treatment of men and women in income tax legislation should then be drawn up.

7. This should take account of the fact that equal treatment of men and women in income tax systems means at the very least:
- individual taxation, which involves making the individual the taxable unit and dispensing with the principle of joint liability for tax debts;
- fair apportionment of realistic tax concessions for dependents (children, elderly relatives, persons unfit for work, etc.).

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[1] This Memorandum was reproduced in 39 *Bulletin for International Fiscal Documentation* 6 (1985) at 262.

[2] Document CES (85) 591 of 4 July 1985.

KENYA:

Budget 1985

"Mobilisation of resources for renewed growth"

Extracts from the Budget Speech 1985 pronounced by the Honourable Professor G. Saitoti, Minister for Finance and Planning on 13 June 1985.

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TAXATION PROPOSALS

Mr. Speaker, I have appraised the House on the international economic situation, the economic crisis facing sub-Saharan Africa, the state of our economy and the policies we intend to pursue in the context of the prevailing situation. I have also indicated that I have a financing gap of K£ 4.1 million.

I now turn to my taxation proposals and, as usual, I would ask, Mr. Speaker Sir, that the rest of my speech be regarded as Notice of a Motion to be moved before the Committee of Ways and Means.

A. Customs tariff

The House will recall that during the last two budgets Government has effected substantial reductions in tariffs on inputs used by a wide range of industries. There has also been an increase in the rate of export compensation. Both these measures have increased the competitiveness of our exports. These measures were also helped by the adjustment of the Kenya shilling which took place over this period.

In spite of these measures our industries still enjoy high levels of protection – higher than consumers have to pay. In this year's Budget I am proposing a package of changes in both customs tariffs and import policies in order to carry further the system of restructuring incentives. This package will also consolidate the gains of the past two years.

Firstly, import tariffs on a wide range of items, namely, raw materials, intermediate inputs to industry and capital goods, will be reduced by an average of 12% of the existing rate where they are currently above 25%. This will provide substantial benefits to the manufacturing sector as well as to large sections of the construction trade and to parts of the agricultural sector. By reducing the cost of industrial inputs, manufacturers of both import competing goods and exports will benefit significantly.

Secondly, Hon. Members are no doubt aware that the Government has recently authorised local assembly of passenger cars. This has necessitated the introduction of appropriate duty structure to ensure that the Exchequer does not lose revenue rightly due to it as a result of the inadequacy in the current tariff structure.

I have, therefore, decided to align the rates of duty on passenger cars so as to reduce the current duty differential between imported complete cars and those which will be locally assembled. In doing this, and in pursuit of the tariff restructuring policy which I have already outlined, it has been deemed necessary to equalise duty on cars of varying engine capacities.

Therefore, with effect from midnight tonight, all passenger cars imported in complete form will be dutiable at 50% irrespective of their engine rating. At the same time, in order to provide incentive to local assembly of cars, all passenger cars assembled locally will have their duty lowered from 35% to 25%.

Thirdly, access to necessary imports is being liberalised through the shifting of a further 317 items to Schedule 1A of the Import Schedules. Thus a large number of consumer goods which are currently protected by both high tariffs and import restrictions will be shifted to the more liberal import licensing schedule.

However, to ensure that local manufacturers of these items are not adversely affected, the tariffs in these items will not be lowered. I should point out that in many cases the local manufacturer receives very high levels of protection against import competition, and has done so for a long time.

In my judgement, the time has come when these firms should start to experience a bit of competition, but in a manner which is fair to the investor as well as the consumer. Items shifted to the Schedule 1A list in every case will have tariff rates which provide local producers with adequate levels of protection.

Mr. Speaker, on several occasions, industrialists have, rightly, complained to me about situations in which the tariff on inputs is greater than on output. I am sympathetic to this situation, and the entire thrust of the reform measures we have taken in recent budgets is to deal with this problem. Until we have finished the rationalisation process, however, it is inevitable that anomalies will remain. But we shall correct these anomalies as they arise.

Finally, the public will have noticed the East Africa Industries Limited has made strenuous efforts in promoting domestic production of rape seed and sunflower to replace imported palm oil as raw material for the manufacture of Kimbo. In order to assist the company in this important endeavour and encourage our farmers to grow these crops, I am removing duty on rape and sunflower seeds.

Mr. Speaker, the measures I have just announced, which take effect from midnight, tonight, will reduce the cost of imports to the manufacturer and consumer by K£ 12 million. The Exchequer will lose a corresponding amount of revenue.

B. Excise tariff

Mr. Speaker, I would now like to make a minor amendment to the excise tariff on cigarettes and tobacco. Hon. Members will agree with me that cigarettes and tobacco are not only a luxury but also a major source of Government revenue. It is therefore necessary that their prices should be kept in line with domestic inflation and that the level of revenue derived from this source be maintained in real terms.

In order to attain these objectives, I propose to raise the levels at which the current rates of excise duty apply by an overall weighted average of 12.1%. This will have the effect of raising the price of some popular brands of cigarettes such Nyota by 50 cents per packet, Sportsman by shs. 1 per packet, Embassy by shs. 1.50 per packet, and the high class brands of Rex and State Express by shs. 1.50 and shs. 2.50 respectively.

Out of the increased receipts arising from this measure, the tobacco manufacturer and traders will receive 38% while the balance of 62% will go to the Exchequer as revenue.

This measure on excise tariff which takes effect from midnight will provide the Exchequer with an additional K£ 6.9 million in revenue.

C. Sales tax

I would now like to turn to sales tax. Firstly, wines. The House will recall that last year I increased that rate of sales tax on wines from around 30 to 75%. This increase, though justified, has created a disincentive to make wines from local fruits. As. Hon. Members are aware, sales tax is levied on the ex-factory selling price in case of local manufactures an on C.I.F. plus duty on imported goods. In the case of wines, it has come to my notice that the tax paid on domestically made wines is significantly higher than that on imported wines because of the fact that tax on local wines includes tax on overheads and profit. It is, therefore, more profitable to import wines than to make them from local fruits.

To correct this anomaly, I propose to reduce sales tax on wines to 35% in order to encourage local production of this product. However, in order to maintain the current level of revenue derived from imported wines, I propose to increase import duty on wines in such a way that the current rate of the combined tax remains unchanged.

Secondly, passenger cars. I have already indicated that I propose to unify the rates of duty on passenger cars irrespective of their engine rating while maintaining adequate protection for locally assembled passenger cars.

Mr. Speaker, while it is my intention to lower marginally the cost of passenger cars, the Exchequer would lose substantial revenue if the current rates of sales tax on unassembled passenger cars were to remain. Therefore, in order to maintain satisfactory levels of revenue while giving the motorist a slightly better deal, I propose to raise the rate of sales tax on unassembled passenger cars from the current 30% to between 40 and 250%, depending on the engine rating. Correspondingly, I propose to adjust sales tax on imported, completely built passenger cars from 70 to 240% to 40 to 400%.

The effect of these measures will be that total tax on passenger cars will be reduced from the current 147 to 818% range to 110 to 650% range, depending on the engine capacity of the vehicle. Considering that there has been very little passenger car importation, I do not expect to lose any substantial revenue by these changes. In fact, I expect to gain substantial revenue as local passenger car assembly picks up and the demand increases as a result of reduced tax rates.

Thirdly, sales tax on beer. Those who are still with me will have by now noticed that I have reduced tax on various items. It is only fair that the Exchequer be somehow compensated by increasing sales tax on luxury consumer goods like beer.

Consequently, I propose to raise the rate of tax on beer by 30% per litre. In addition, Kenya Breweries has requested a price increase of 10% per half-litre bottle to meet increased costs of barley and other manufacturing costs. The Government has, after careful consideration, accepted their request and the price of beer will therefore go up by 25% per half-litre bottle with pro-rata increases in other sizes with effect from midnight tonight.

Finally, the rate of sales tax on complete buses is 30% while that of bus chassis and bus bodies when sold separately is 17%. Bus operators have therefore always ensured that they buy the chassis and the body separately in order to escape the higher rate of tax on completely built buses. I have considered this revenue loophole and, since I do not intend to hike public transportation costs. I have decided to lower the rate of tax on buses to 17%. This will enable bus operators to buy completely built-up buses from the same manufacture without incurring additional tax and expenses.

Considered together, these changes in sales tax, which take effect from midnight tonight, will provide the Exchequer with K£ 20 million in additional revenue.

D. Export compensation

Mr. Speaker, the Government accords high priority to export promotion. It is for this reason that various measures have been put in place to provide manufacturers with appropriate incentives. Among these incentives are the continued reduction in duty on imported raw materials, the establishment of PTA, exemption of exports from sales tax, and most important, the payment of export eligible goods.

These measures have not yet boosted our exports to the level I would like to see and I am therefore making additional amendments to the Local Manufactures (Export Compensation) Act in the hope that these measures will give impetus to increased exports in the following ways.

It will be recalled that some three years ago the Act was amended to provide for incremental export compensation. The rate of this compensation is currently 10% of any increase in the value of goods exported in a fiscal year over the value of goods exported in the previous fiscal year. The incremental compensation was also to be paid to new exporters.

As the exporters are already aware, it has taken the Customs & Excise Department a long time to effect the additional compensatory payments, mainly as a result of the problems associated with satisfying ourselves that those claiming it are eligible. Indeed, we have had unfortunate experience with fictitious claims based on dubious exports.

Although payments have already started, there are several facts which cast doubt on the advisability of maintaining this additional compensation. Firstly, the additional compensation is being paid mainly for price variation and not for increased exports. Therefore, as a result of inflation and the adjustment of the Kenya shilling, additional compensation becomes due and payable without physical increase in exports. Secondly, since new exporters are eligible for this compensation, all an existing exporter need do is to change his company's name every year in order to qualify. Thirdly, there is the potential danger that an established exporter could use the compensation as a good reason to lag payments in order to qualify for the payment. This would not be in the interest of our balance of payments.

I have considered the merits and demerits of this additional compensation and have come to the conclusion that it should be abolished with immediate effect. However, all outstanding payments will be paid, including increased exports for the financial year ending 30th June, 1985.

Finally, I propose to increase the general rate of export compensation from 15 to 20%.

Mr. Speaker, I would like to take this opportunity to challenge local manufacturers to take full advantage of these new measures and embark on a sustained export programme. Only by boosting out export potential can we sustain growth of our economy.

These measures on export compensation will cost the Exchequer K£ 5 million in lost revenue.

E. Income tax

I shall now turn to income tax. Over the years, the Income Tax Act has been amended regularly with the view to making it easier to administer and occasionally to compensate the taxpayer for inflation. I propose to continue this trend this year.

Firstly, section 19A of the Act was introduced in the Finance Act of 1984 to deal specifically with the taxation of cooperatives. I am proposing to make a few amendments to that section, but these amendments are entirely intended to clarify and tidy up the drafting of that section, without making any substantive change in the Act.

Secondly, I propose to amend paragraph 38 of the First Schedule to provide that where any company has proved beyond doubt that it promotes development of residential housing, I shall advise to commissioner to make it eligible to operate tax-free interest housing development bond accounts.

Thirdly, Hon. Members will agree with me that this Budget would be incomplete if it did not address itself to our agricultural sector. We are all aware that after the devastating drought of 1984 our farmers have been financially strained, and many are still pondering over the losses they incurred. Despite these setbacks, our farming community has taken full advantage of the long rains.

In response to the efforts taken by the farmers, and in order to give them a shot in the arm, I propose to increase farmworks deduction in such a way that they can wirte off all their allowable capital costs against profits in three years instead of five years, as is the case now. To give the farmers early benefits of this measure, I propose to back-date it to January this year. The immediate effect of this proposal is that farmers will pay less tax on their 1985 proifts. Although I stand to lose some revenue, I expect the loss to be more than compensated by increased agricultural output.

Fourthly, it has been our practice in the past to review tax payable by individual in order to compensate them for inflation. The last time that this was done was in 1981 and, although that rate of domestic inflation has been almost halved since that time, it is necessary to maintain this trend.

I therefore propose to give further tax relief this year by widening tax brackets by £ 300 so that the first K£ 1,800 instead of the first K£ 1,500 will be taxed at shs. 2 per pound. The next bracket of £ 1,800 will be taxed at shs. 3 and so on, moving up in slabs of £ 1,800 up to £ 12,600, which will be taxed at the top rate of shs. 13.

Thus, a taxpayer earning K£ 2,400 and currently paying tax of shs. 5,700 will pay shs. 5,200 thereby saving shs. 500. I am, however, leaving the tax rate undisturbed rising from shs. 2 to shs. 13 for every shs. 20. The same brackets and rates will apply to a wife's employment income. This change will have the effect of increasing the disposable income to the taxpayer.

Fifth, Mr. Speaker, having given the working population some compensation for the rising cost of living, it is only fair that we do not forget those who have retired after serving this country with loyalty and dedication. Indeed, we owe our prosperity to their unflinching service in the past. I am, therfore, proposing to amend the law in order to increase the amount of tax-free pension income from K£ 2,500 to K£ 5,000. In addition, this amount will not be taken into account when calculating income tax which the pensioner may be required to pay on other incomes.

Sixth, as I have already indicated, it is government policy to encourage industrialisation, especially in the rural areas. One such form of encouragement is the investment deduction which is allowed to new industries setting up factories outside Nairobi and Mombasa. This deduction is given as a bonus over and above normal depreciation of cost of factory premises and machinery installed therein. This bonus has been maintained at 20% of qualifying expenditure for many years.

In order to boost rural industrialisation, I propose to increase the rate of this deduction from 20 to 50%. This investment deduction also applies to tourist hotels, and hope it will encourage the construction of more hotels and lodges in the country's game reserves to cater for the increasing tourists.

Finally, capital gains tax. I have received numerous representations from members of the public, companies and the Nairobi Stock Exchange requesting me to consider abolishing capital gains tax on the ground that the tax inhibits capital and share mobility and, therefore, economic growth. I know also that there are very good reasons for maintaining the tax. However, there seems to be general concensus that the tax does to some extent inhibit trading in real estate – and hence development.

I have carefully weighed the pros and cons of this tax and decided – in line with this year's Budget theme – to suspend it with effect from tomorrow. We shall, however, continue to watch the situation carefully to see if its abolition will bring us the development promised by its opponents. In view of the current low rates of this tax, I expect to lose minimal revenue from this measure.

Taken together, the measures I have announced today on income tax will cost the Exchequer some K£ 14 million in lost revenue.

Mr. Speaker, I would now like to turn to a number of miscellaneous taxes.

F. Hotel accommodation tax

Legal Notice No. 178 of 1980 exempts from tax any premises with less than ten beds for hire, situated in a market established within a jurisdiction of a country council. This measure was intended to assists the small-time businessmen seeking to establish themselves in rural areas. However, it has been abused by unscrupulous businessmen who remove extra beds during the day only to return them at night.

In order to close this loophole, I have decided to revoke this legal notice with effect from midnight tonight. This revocation will provide the Exchequer with an additional K£ 100,000.

G. Second-hand motor vehicles purchase tax

Hon. Members will recall that Second-hand Motor Vehicles Purchase Tax has not been adjusted over the last six years. During this period, the cost of registration has gone up mainly as a result of the increased transfer arising out of the fact that there has been limited importation of new cars. It is only fair that the Exchequer maintains its fair share of this increased motor trade.

I therefore propose to reclassify the various sizes of motor vehicles into realistic engine categories and effect a modest increase in transfer tax. It is also proposed to increase second-hand motor vehicle dealer's licence fee from shs. 1,000 to shs. 2,000. Considering the high prices that the second-hand motor vehicles are fetching, I consider this increase reasonable.

As a result of these minor changes, the Exechequer will realise an additional K£ 75,000 in revenue.

H. Traffic Act

Mr. Speaker, fees and other charges levied under the Traffic Act have remained stagnant for some years. In the intervening period, the cost of maintaining roads has increased considerably as is evident from the vote of the Ministry of Transport and Communications. You will also have read in the newspapers about the increasing number of forged licences. In order to close this tax loophole and raise additional revenue, I propose to effect the following measures.

First, as the cost of materials for making number plates has risen considerably since 1979. I propose to raise number plates charges from shs. 150 to shs. 250 per pair and shs. 100 to shs. 150 per single plate.

Second, I propose to effect a modest increase in licence fees covering all classes of vehicles. These increases will be graduated to maintain the current structure where the higher the engine rating or the heavier the vehicle the higher the cost of the road licence fees.

Third, Mr. Speaker, and in order to ensure that I realise the proposed revenue in full, the law will be amended to provide introduction of a non-counterfeit "Validation Licence Certificate" which will bear the same number as the licence and which will be affixed to the identification number plates.

It is estimated that these changes will provide the Exchequer with an additional K£ 2.5 million in revenue.

I. Video tax bill

Mr. Speaker, the public will have noticed the recent mushrooming of video cassette libraries throughout the Republic and particularly in the major urban centres. The effect of this is that there has been a major reduction in cinema audiences. Cinema operators have complained to me on the grounds that these video libraries offer the same films but – unlike cinema – they do not pay entertainment tax. The situation is, therefore, inequitable.

I have examined the complaint carefully and I am convinced that the cinemas have a case. Besides, those who can afford the luxury of watching films in the comfort of their sitting-rooms can also afford to make a contribution to the Exchequer.

I have therefore today published a new Bill intended to introduce an annual licence fee of shs. 2,000 on every video library, irrespective of where it is situated. In addition, I propose to introduce a tax of shs. 4 to be paid every time a video cassette is leased. In order to give time to video libraries to register and for the Controller and Inland Revenue to set up the necessary administrative machinery to collect this tax, the Bill shall come into force on 1st July 1985.

I expect to raise K£ 40,000 from this source.

J. Stamp Duty Act

Fees charged under the Stamp Duties Act have not been revised since 1973. However, during this time the cost of registering various instruments falling under this Act has continued to increase. Unless these charges are regularly adjusted to keep up with rising costs, there is a danger of subsidising services which ought to pay for themselves. I have also abolished capital gains tax, and there is need to recoup revenue lost in this regard. In view of these facts, I propose to raise the rates of stamp duties in the manner indicated in the Schedule to the Finance Bill.

I expect to raise an additional K£ 3 million from these adjustments.

K. Insurance & Hire Purchase Companies

Licence fees charged under the Insurance Companies Act and the Hire Purchase Act have remained at very low levels in spite of the growing business being enjoyed by these companies. I therefore propose to increase licence fees on insurance companies from shs. 10,000 to shs. 100,000, while that of hire purchase companies will be increased from shs. 1,000 to shs. 4,000.

L. Building Societies Act

Although some building societies perform functions which are very similar to financial institutions licensed under the Banking Act, the law does not provide for annual licence fees, as is the case with the financial institutions, I suspect this is the major reason why there has been a rapid expansion of these societies. Although this in itself is a move in the right direction, there is need to ensure that those societies which perform similar functions to financial institutions are treated similarly in their contributions to the Exchequer.

These societies should therefore pay licence fees equal to that paid by financial institutions. However, in view of the fact that there are some societies which have been registered solely to assist their members to acquire houses, I think it would be unfair to require these to pay a high annual licence fee. I am therefore proposing to introduce an annual licence fee for building societies of shs. 50,000. The necessary amendments to the law will be worked out such that all building societies will be required to obtain the first annual licence by January 1986.

In order to encourage mobilisation of savings in the rural areas, no licence fees will be levied on branches of building societies outside Nairobi, Nakuru, Mombasa and Kisumu, where the fee will be shs. 20,000.

M. Liquor Licensing Act

Licence fees charged under the Liquor Licensing Act were last increased in 1979. Bar owners have of course had their retail margins increased each time that we have awarded a price increase to Kenya Breweries. It is only fair that the Government shares in these margins. I therefore propose to increase liquor licensing fees by 50%. This increase will give the Exchequer an additional K£ 200,000 in revenue.

N. Trading Licensing Act

Mr. Speaker, I have introduced measures, which as I have already indicated, will speed up economic recovery. In the process of this recovery, I expect trader to realise increased margins as the economy imporves. However, trade licence fees have not been adjusted over the last six years. In order to maintain the government's share of the increasing trade margins, I propose to double trade-licence fees. This will provide an additional K3 1 million in revenue.

O. Banking Act

Mr. Speaker, newspaper reports on financial institutions have generated fear among the public for the safety of their deposits and raised doubts about the management capabilities of some of the institutions. This has resulted in the movement of funds to the older or better-established banks and financial institutions. One of the major causes of this uncertainty has been the recent problems facing one of the financial institutions.

In the industrialised countries, the collapse of banks and finance houses is a phenomenon which has been accepted in financial circles, and measures have been put in place to deal with this kind of problem. However, the recent crisis has caused a major stir in public and private financial circles – the more so because the event is the first of its kind in the history of banking in Kenya.

As originally enacted the Banking Act was intended to regulate a small financial sector. With the recent rapid growth of banks and financial institutions, it is now necessary to take steps to eliminate some of the weaknesses arising from the rapid growth of the banking industry. For some time the Government has been concerned about the potential instability in the banking industry arising from this growth. Major studies have already been undertaken and more efforts have been made to examine the financial conditions of various banks and financial institutions and to pinpoint their weaknesses.

Amendments to the Central Bank of Kenya Act and the Banking Act, designed to strengthen the banking industry, have been considered and some have already been passed by the House. The recently enacted section 20(1) of the Banking Act, for example empowers the Central Bank to appoint an advisor to a bank or financial institution if the affairs of the bank or institution are not being conducted in a satisfactory manner. If a bank or financial institution deteriorates significantly, the Central Bank can appoint any competent person to assume the management and conduct the affairs of the bank or institution.

However, it is clear from the studies I have just referred to that it is necessary to enact new measures to ensure that the financial system develops on a sound, equitable, and fair basis in the future. Accordingly, I have today published the Banking (Amendment) Bill which, when approved by this House, will take us further in this direction.

Mr. Speaker, the Banking (Amendment) Bill contains substantial provisions which cannot be fully dealt with in today's forum. I shall have time to explain these amendments in detail when the Bill is debeted in this House. I would, however, like to highlight the main provisions of the Bill. These include adequate capital requirements, maintenance of asset quality, and appropriate liquidity levels; minimum qualification for management cadres and key personnel; prudent lending policies and maintenance of strong internal controls; penalties for abuses of ceilings on interest rates and for flouting the law; new powers to deal with insolvent banks and financial institutions; a programme of disengagement for those institutions which are highly dependent on parastatals' deposits; mandatory deposit insurance scheme for all banks, financial institutions, and deposit-taking building societies operating in the country; and increased powers to deal with building societies operating in the country; and increased powers to deal with building societies.

Mr. Speaker, while still on banking, I would like to mention something about agricultural credit. Currently, banks and financial institutions are required to lend 17% and 10%, respectively, of their deposits to agriculture, I am sorry to have to report that some banks and financial institutions have not met this requirement. In view of the importance of agriculture to the economy, I am directing the Central Bank to ensure that this lending requirement is complied with. Those banks and financial institutions which are unable to meet the target directly should make their contribution indirectly through other institutions involved in agricultural lending.

I think the Hon. Members will agree with me that while most other sectors of the economy have experiences reduced profits in the recent past, the banking industry has continued to enjoy sustained level of profits. It is only fair that the Exchequer shares in these high profits. Accordingly, I propose to raise licensing fees charged to banks and financial institutions from shs. 150,000 to shs. 200,000 for headquarters; shs. 75,000 to shs. 100,000 for branches within municipalities; shs. 30,000 to shs. 50,000 for branches in town council areas; and shs. 15,000 to shs. 20,000 for branches in urban council areas. In order to encourage banks and financial institutions to establish branches in the rural areas, no fees will be charged to branches established in market centres.

The increased licence fees on banking licences will provide the Exchequer with an additional K£ 220,000.

CONCLUSION

Mr. Speaker, the primary objective of this year's Budget is to consolidate further the gains we have achieved during the last two years and reinvigorate economic recovery after last year's devastating drought. I have emphasised the need to revive and promote agriculture as the mainstay of the economy. I have also given the public tax relief and reaffirmed our commitment to control inflation so as to maintain sustainable economic growth. Lastly, I have outlined the measures the Government intends to take to restructure production and have outlined the system of incentives intended to promote growth of the manufacturing sector.

The measures I have announced today will provide further rationalisation of the incentives for the manufacturing industry, will increase the availability of goods in the economy, will stimulate production for both the domestic and the export markets, and should – on balance – reduce domestic costs of production in the manufacturing sector. Those producers who have been conscientious about containing their costs of production, and who have sought ways of increasing efficiency and productivity of their labour force and their capital stock, will be in a position to benefit most from this package of incentives.

Mr. Speaker, mobilisation of domestic resources implies not only an increase in the resources devoted to investment and development, but also a relative decrease in our dependence on foreign resources. It suggests the need to increase domestic savings – both from Government, through prudent expenditure policies, and from private firms, farms, and households – so that relatively less foreign aid and domestic investment is required to achieve growth. Domestic mobilisation of resources also suggests the importance of promoting exports and conserving imports so as to preserve our foreign exchange.

The theme of "Mobilisation of Domestic Resources for Renewed Economic Growth" is a central requirement for attainment of the basic development goals of the Kenya Government as outlined in the current Development Plan, such as employment creation, food security, and a more equitable distribution of income, especially between rural and urban areas. Thus, the structural adjustment policies I have outlined today are designed to enhance employment creation in the agriculture, industry, and service sectors of our economy. Agriculture remains the largest sector of Kenya's economy – the source of most of its jobs and most of its exports – and must grow vigorously if the rest of the economy is to prosper.

Taken as a whole, the new taxation measures introduced today will bring an additional K£ 3.4 million in revenue. The balance of K£ 0.7 million will be financed from change in Exchequer cash – thus closing the gap. This represents an overall deficit of 4.3% of GDP in the 1985/86 fiscal year. I would have liked to see a lower deficit but, considering the adverse effects of the drought which will take some time to remove, the need for increased Government services will continue to be necessary. I am, however, convinced that with the expected economic recovery, this level of deficit is sustainable.

Mr. Speaker, the Budget policies I have outlined today do no exhaust all the important structural adjustment policies that are required to be considered in the coming financial year. The Treasury is currently coordinating the preparation of a Sessional Paper on the major policy issues raised in the 1984-1988 Development Plan and will present a draft during the first half of the coming financial year.

In conclusion, Mr. Speaker, I have today outlined policy measures which I believe will consolidate the gains achieved under the programmes of stabilisation and structural adjustments of the economy. Indeed, I have spoken on policies aimed at getting the economy growing by means of a general expansion in agriculture and industry.

Further, I have expressed my optimism that in spite of the recent setback, the economy is in a good position to enable us to recover from the drought, out other problems behind us, and launch a period of economic progress. As we move on the road to progress, we are comforted by the enlightened leadership of H.E. the President whose Nyayo philosophy of peace, love and unity remains a guiding star.

CONFERENCE DIARY

DECEMBER 1985

British Branch of I.F.A.: Taxation aspects of investment into Spain and Gilbraltar. London (United Kingdom), 2 December (English).

European Study Conferences Limited: 7th Annual ESC Conference on International Transfer Pricing for Multinationals. London (United Kingdom), 3 December (English).

European Study Conferences Limited: 8th Annual North Sea Continental Shelf Taxation Conference. London (United Kingdom), 5 and 6 December (English).

Institut für Ausländisches und Internationales Finanz- und Steuerwesen der Universität Hamburg: 4. Hamburger Tagung zur internationalen Besteuerung. Steuerreform und internationaler Wettbewerb – steuerliche Probleme der Finanzierung und Bilanzierung bei internationaler Geschäftstätigkeit. Hamburg (Germany), 6 December (German).

European Study Conferences Limited: How to Manage Corporate Taxes. London (United Kingdom), 6 December (English).

Institute for International Research: 1985 China update. Hong Kong, 9 and 10 December (English).

European Study Conferences Limited: How to Dispute Revenue Decisions. London (United Kingdom), 11 December (English).

Management Centre Europe: Financial Planning and Control (including: transfer pricing). London (United Kingdom), 9-12 December (English).

JANUARY 1986

British Branch of I.F.A.: Current developments and proposed changes in U.S. taxation. London (United Kingdom), 14 January (English).

Zentrum für Unternehmungsführung: Steuertagung Schweiz–Deutschland 1986 (Seminar), Zürich (Switzerland), 20-21 January (German).

Zentrum für Unternehmungsführung: How to establish and manage a U.S. subsidiary. Interlaken (Switzerland), 27-29 January (German).

MARCH 1986

International Tax Planning Association: Gibraltar Seminar (including: Gibraltar as a financial centre: Gibraltar as a base for international insurance; foreign investment in Spain). Gibraltar, 13-14 March (English).

MAY 1986

International Tax Planning Association: Annual Conference (including: the RA/NDA: U.S. tax planning for the non-domiciled resident alien; minimising FIRPTA tax on dispositions of U.S. real estate). Santa Fe (U.S.A.), 19-21 May (English).

SEPTEMBER 1986

40th Annual Congress of I.F.A.: I. Transfer of assets into and out of taxing jurisdiction. II. Currency fluctuations and international double taxation. New York (U.S.A.), 7-12 September (English, French, German, Spanish).

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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.

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Zentrum für Unternehmungsführung, Schulstrasse 7, 8802 Kilchberg, Switzerland.

MCGEORGE SCHOOL OF LAW ENTERS THE INNS OF COURT

McGeorge School of Law of Sacramento, California, has expanded its European Programs to include London, England. The program will be offered from 8-28 June 1986 at the School of Law of the Inns of Court at Gray's Inn. The new program was recently approved by the A.B.A., a culmination of the diligent efforts of Dennis Campbell, Director of the McGeorge International Programs, and Associate Dean Claude D. Rohwer.

Moving into the school of Francis Bacon will provide participants a chance to sample the training regime of barristers and view the origins of the common law system. Sir Robert Megarry will preside over opening ceremonies for the program, and Lord Nathan will welcome participants at a reception.

The London Program is expected to be a fine addition to the exceptional summer sessions already available: the Edinburgh Institute on International Business Transactions (29 June – 22 July), the Salzburg Institute on International Legal Studies (5 July – 26 July), and the Budapest/Vienna Institute on East/West Law and Relations (23 July – 2 August).

The summer sessions are further complemented by the Internship Program, which offers participants a working relationship in a law firm chosen from more than 15 different countries, and which may lead to an LL.M. in Business and Taxation – Transnational Practice.

Information on the programs is available from the McGeorge office in Salzburg (Box 19, A5033 Salzburg, Austria) or the International Programs Office, 3200 5th Avenue, Sacramento, California 95817 (tel. 916/739-7195).

SIERRA LEONE:

Budget 1985-86

Extracts from the Budget Speech pronounced on 29 June 1985 by the Honourable Joe Amara-Bangali, M.P., Minister of Finance

. . .

Taxes on income and profits

62. Collection of these taxes in 1984/85 is 75.8 Le million, an increase of 26% compared to previous year's figures. As will be observed in the budget document, company tax leads this increase. With the strengthening of the Income Tax Department in terms of staff and administrative facilities and on the basis of very successful performance of the department this year, our target for 1985/86 has been set at 95.0 Le million, an increase of 25% compared with the current year.

63. Mr. Speaker, Honourable Members, having regard to the increase in the cost of living, especially for the lower paid workers, I am happy to inform this House that it is proposed to raise the threshold limit at which resident employees start to pay income tax from 1,800 Le per annum to 2,400 Le per annum, so as to ease the financial burden on a large number of low income earners.

Domestic taxes on goods and services

64. These taxes which comprise excise duties, different types of licences fees and other taxes on services registered 66.6 Le million in 1984/85, an increase of 32% over 1983/84 figures. In 1985-86, these taxes, with an increase of 24%, have been projected to be 82.4 Le million.

Taxes on international trade and transactions

65. Mr. Speaker, Honourable Members, I am pleased to report to this House that our collection on import duties and fees in 1984/85 has been increased by 48% amounting to 105.3 Le million. Although in the last four months of current fiscal year, the application of the new exchange rate has contributed to this sum, a review of the collection in the first eight months of the year shows a considerable increase over 1983/84 fiscal year. With the application of existing exchange rates for customs valuation for the whole fiscal year, we expect a considerable increase of returns from this source in 1985/86 (17.9 Le million an increase of 67% over 1984/85). In the area of export duties, it is hoped that with the rationalization of SLPMB's operations, it will be in a position to contribute substantially to Government revenue. In this regard, we have estimated a contribution in the region of 44.8 Le million.

. . .

Tax proposals

75. In order to meet part of growing government expenditures, the Ministry of Finance has, in collaboration with revenue collection Ministeries and Departments, worked out a package of adjustments in the rates of licences and duties as well as charges for services rendered by Government. In increasing service charges, the cost of services has been taken into consideration. The package, however, has been designed in such a way, so as not to affect low income groups. Here are proposals on the main components of the package:

(i) Customs and excise

(a) The import licence fees and invoice entry fees under-mentioned luxury items are increased from 30% to 40% *ad valorem:*

Wine
Spirit
Perfumery
Cosmetics and toilet preparations
Carpets
Video recorders/producers
Tape recorders
Washing machines
Television sets

(b) The export duty on diamonds is increased from 3% to 5% *ad valorem;*

(c) The royalty on gold is increased from 3% to 5% *ad valorem.*

(ii) Immigration

Cost of new passports raised from 25 Le to 20 Le;
Passport renewals raised from 25 Le to 30 Le;
Multiple visas raised from 30 Le to 25 Le;
Single visas raised from 10 Le to 20 Le;
Non-citizens registration raised from 10 Le to 20 Le;
Non-citizens petty traders registration raised from 10 Le to 100 Le;
Non-citizens (Africans) in gold and diamond business registration raised from 10 Le to 500 Le.

(iii) Administrator and Registrar-General's Department

Land taxes (per acre) Central Freetown raised from 100 Le to 300 Le per acre;
East and West of Freetown raised from 50 Le to 150 Le;
Greater Freetown area and other villages raised from 20 Le to 100 Le.

(iv) Business registration

Business name registration fee raised from 4 Le to 20 Le;
Certified copy of business name fees raised from 2 Le to 10 Le;
Certified copy of application fees raised from 2 Le to 10 Le;
Sole proprietor – citizen registration fees raised from 5 Le to 25 Le;
Sole proprietor – non-citizen (African) raised from 50 Le to 300 Le;
Sole proprietor – non-citizen (others) raised from 100 Le to 800 Le.

(v) Partnerships

Domestic fees raised from 50 Le to 200 Le;
Citizen fees raised from 150 Le to 400 Le;
Foreign fees raised from 250 Le to 1,000 Le.

(vi) Companies

Domestic registration fees raised from 50 Le to 200 Le;
Citizen fees raised from 150 Le to 400 Le;
Foreign fees raised from 250 Le to 1,000 Le.

(vii) Renewal of licences

Sole proprietors – citizens fees raised from 5 Le to 25 Le;
Sole proprietors – non-citizens (African) fees raised from 50 Le to 300 Le;
Sole proprietors – non-citizens (others) fees raised from 200 Le to 800 Le.

(viii) Renewal of licences – Partnerships

Non-citizens fees raised from 50 Le to 400 Le;
Domestic fees raised from 100 Le to 200 Le;
Foreign fees raised from 250 Le to 1,000 Le.

(ix) Renewal of licences – partnerships

Domestic fees raised from 100 Le to 200 Le;
Citizen fees raised from 250 Le to 400 Le;
Foreign fees raised from 500 Le to 1,000 Le.

(x) Posts and telecommunications

Telephone charges – public servants – the flat rate of 6 Le per month charged raised to 15 Le per month.

(xi) Civil aviation

Airport tax is increased from 15 Le to 20 Le.

Government will continue to examine and adjust the rates of fees charged for services such as external postal services, registration of legal instruments, trade marks, etc.

news

SRI LANKA BRANCH

Annual general meeting

On 4 July 1985 the second annual general meeting of the Sri Lanka Branch of IFA was held. During this meeting an Executive Committee of 6 members was elected. The following principal officers were appointed:

Chairman	Mr. Samy M. Pasupati
Deputy Chairman	Mr. Hugh Molagoda
Secretary	Mr. R.G.L. de Silva (re-elected)
Treasurer	Mr. A. Sivathondan

"S. Ambalavaner Memorial Lecture" by Finance Minister Ronnie de Mel

The Executive Committee of the Sri Lanka Branch of IFA organized, on 23 August 1985, a public lecture to be delivered by Mr. Ronnie de Mel, Minister of Finance and Planning. The following is a report on the Minister's speech.

Fiscal policy for development in the Third World

In delivering the inaugural "S. Ambalavaner Memorial Lecture" in Colombo on 23 August 1985 at the Auditorium of the Institute of Chartered Accountants, the Minister of Finance and Planning of Sri Lanka, Mr. Ronnie de Mel, said that he was greatly honored at being invited to deliver this inaugural lecture in remembrance of his old colleague and friend, S. Ambalavaner, an eminent tax lawyer and Founder Chairman of The International Fiscal Association (Sri Lanka Branch).

Minister de Mel said that fiscal policy interested S. Ambalavaner most, fiscal policy not as a vehicle for advancing the interests of a particular class or group, but as an instrument for development, not only of Sri Lanka, but also of the entire Third World. The subject chosen for this lecture – "Fiscal Policy for Development in the Third World" – was therefore a fitting tribute to his memory.

In his lecture Mr. de Mel said that all governments sought to express, through their policies and actions, the aspirations and goals of societies within which they operated and the people whom they served. In this respect, the Third World countries have one clear objective in common; they all have economic development as their goal, so that together with political freedom and social justice they could ensure a better quality of life for their people.

It was from these aspirations that the fiscal policies of developing nations derived their meaning and direction, the Minister added.

In general terms, he said their goals were not fundamentally different from considerations of allocative efficiency, economic growth, optimum income distribution and stability, which formed the basis of fiscal policy in advanced countries. He said that Third World countries were characterised by low per capita real incomes and could readily be labelled "poor", in terms of non-monetary indicators such as diet, housing, transportation, health and education. Further, he said, not only were these countries poor, but they were caught in the vicious circle of poverty – low income leading to a high propensity to consume resulting in low savings and in turn leading to low rates of capital formation and back to the low income – the "poverty trap".

In the case of advanced countries, the Minister said, the response to the stimulus of compensatory finance was relatively swift, smooth and even. A reduction or increase in public works or transfer payments translated much more readily into lower or higher levels of employment and income.

Mr. de Mel emphasized that the key to sustained development in the Third World was capital accumulation and this was dependent on savings. The policy makers of Third World economies were faced with extremely low levels of income and therefore little remained as savings after meeting the pressing demands of mere subsistence in the lower income strata. In this context, fiscal policy makers had the very difficult task of wresting, from the pitifully low output of these countries, sufficient savings to finance economic development programmes without undermining the incentive for work, enterprise and higher productivity. He also stressed the importance of exports from Third World countries to stimulate their economic progress.

The lecture was well attended. Samy M. Pasupati presided and Secretary R.G.L. de Silva proposed the vote of thanks.

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Communication

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Postfach 111932
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Belize

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A Great Era Ends
Professor J. van Hoorn Jr. Retires

On 30 November 1985 Professor J. van Hoorn Jr., Chief Executive of the Bureau, having reached the age of 65, has retired. Having been associated with the Bureau since 1946, Professor van Hoorn has attained a recognized status in the international tax world.

His retirement marks the end of the second major era in the Bureau's history. In order to evaluate the significance of Professor van Hoorn's tenure at the Bureau one need only review the history of the Bureau.

The first era began in 1938, when Professor Dr. P.J.A. Adriani founded the Bureau. Dr. Adriani believed that a growth in world trade, which was widely expected, would result in a need for information on what might loosely be called "international taxation", in particular the impact of the interrelationship between national tax systems. To this end the Bureau was formed and housed in a few rooms scattered throughout the premises of the Amsterdan Municipal Tax Office. This modest start, which required the sharing of telephones, was grossly inadequate and inefficient, but because of financial limitations no better facility was available. The material then at the Bureau's disposal was very modest compared to the Bureau's present collection of books, journals and other documents.

As Professor van Hoorn stated in 1954, when Professor Adriani stepped down and the Board of Trustees appointed Professor van Hoorn to take over, the Bureau has "grown from a rather feeble infant into a sturdy lad". At that time he was faced with a tremendous task. In the first place he had to decide in which direction the Bureau should develop, and in the second place where to find the means to finance such a development. After a number of years of preparation, he saw – and seized – the "golden" opportunity by using the Bureau's research materials and the expertise developed within its small staff. The policy which he formulated and which lay at the heart of the Bureau's success was to use the results of the Bureau's research for publication and offer these to the international practitioner.

In 1961, within a few months of the decision to present a practical journal, the Bureau delivered *European Taxation*. It was no small feat to acquire the knowledge of printing and publishing procedures necessary to present a monthly journal of quality. At that time, no commercial publisher saw a market for such a journal, and the Board of Trustees looked with obvious apprehension at the idea that the Bureau should publish such on its own account. Professor van Hoorn's vision proved to be correct. *European Taxation* was published and delivered to tax experts the world over, and became an overnight success.

Prof. J. van Hoorn Jr.

With this success and the new found financial capacity created by the popularity of *European Taxation*, Professor van Hoorn made his next move. He discovered that the old city gate, the Muiderpoort – constructed in 1771 – was not being used by the city. Professor van Hoorn was able to convince the Municipal Authorities that there was no better destination for the building than using it as the headquarters of the International Bureau of Fiscal Documentation. The Municipal Authorities were highly supportive of Professor van Hoorn's plan and went so far as to take care of a complete restoration of this monument to make it suitable for the Bureau's needs. Only a nominal rent was charged.

Any surplus of receipts over expenses accruing from the sale of the Bureau's publications could be used for pure research purposes, or to finance publications which – although important – would clearly result in a loss, and – in later times – for the training of young lawyers, in particular those from developing countries. This formula met with great success and resulted in a situation in which information from parties, who normally had little contact with each other, found its way to the Bureau where it was prepared for dissemination to the world at large and the benefit of all.

Thereafter, in rapid succession, other publications appeared, some as a result of the initiative of staff members. These publications strictly followed the philosophy and guidelines set by Professor van Hoorn in that they are structured on a common outline independent of purely domestic systems and based upon an analytical approach to the problems, thus making precise comparison possible; in that they are in essence prepared by or at the instruction of the Bureau's own staff; and in the sense that the Bureau can at all times take full editorial responsibility because its staff has available the original source material. In this way and on this basis first the *Supplementary Service to European Taxation* and then a series of loose-leaf *Guides to European Taxation* were prepared and published. Gradually, other parts of the world were covered. *Tax News Service* appeared in 1965. The *Handbook on the U.S.-German Tax Convention* appeared in 1966; *Corporate Taxation in Latin America* in 1970; *African Tax Systems*, in an English and French version, in 1971-1972; *Taxes and Investment in the Middle East* in 1977; and *Taxes and Investment in Asia and the Pacific* in 1978. They all followed the same formula set by Professor van Hoorn. In addition, various monographs have been prepared by experts invited by Professor van Hoorn, one series being a joint venture with the International Tax Program of Harvard University Law School.

Professor van Hoorn has worked hard to maintain the high ideals of the Bureau as he envisioned them. He has consistently resisted pressure to make the Bureau a commercial enterprise. The results are seen in the Bureau itself, an independent research institute which is self-supporting, and, thereby void of influence from governments, corporations or individuals.

During this period the Bureau's staff expanded from 5 in 1954 to more than 55 in 1985 composed of about 10 different nationalities with reading capabilities of some 12 or more languages. Nobody will forget that the pushing power behind this colossal expansion was Professor van Hoorn. He gave the staff support and direction, motivating all parties involved to excel and perfect the Bureau's activities.

While the Bureau was blossoming within, Professor van Hoorn dedicated himself to establishing and maintaining contacts with literally hundreds of tax experts from every corner of the world. Through his professionalism he convinced many eminent tax specialists to cooperate with the Bureau in various ways and developed a network of correspondents that keeps the Bureau up-to-date on all the tax news in virtually every country in the world.

In order to maintain these international contacts Professor van Hoorn decided that, in addition to his many responsibilities at the Bureau, he should travel, and so he travelled to the far ends of the earth, leaving few countries untouched in his efforts. In most of these countries he gave lectures further enhancing the Bureau's prestige. His communicative skills were soon discovered and were much sought after. Not only was he often invited to speak, but also, in later years, he chaired numerous international tax conferences. Moreover, as a consultant he actively participated in tax seminars organized by such international organizations as the Economic Commission for Africa, the U.N. Economic and Social Commission for Asia and the Pacific and the Inter-American Center of Tax Administrators. The recognition of his capabilities in this field culminated in his professorships at the Free University of Brussels (Belgium), the College of Europe in Brugge (Belgium), the European Institute of the University of Amsterdam (the Netherlands), and at the University of Genoa (Italy).

This necessarily incomplete survey of Professor van Hoorn's activities in the area of international taxation should mention another of his major achievements: the creation of a research center for the Asian-Pacific region. The concept of such a research center emanated from four seminars on foreign investment and tax administration held in Manila (Philippines), Tokyo (Japan), Sydney (Australia) and Bangalore (India) which were chaired by Professor van Hoorn. Two important recommendations were made at these seminars. In the first place, a tax service covering the Asian-Pacific region should be published (which resulted in the Bureau's 8-volume loose-leaf work on Taxes and Investment in Asia and the Pacific). The second recommendation concerned the creation of a permanent institute for research and information. This resulted in an institute modelled after the Bureau being formed with as its special mandate the research of tax aspects of economic development in the Asian-Pacific countries. After the Bureau's Board of Trustees gave its formal approval for the Bureau to sponsor it as a separate entity, it was incorporated as a charity under Singapore Company Law on 12 November 1982. In July 1983 the *Asian-Pacific Tax and Investment Research Centre* (APTIRC) was inaugurated in Singapore with Professor van Hoorn as the first Chairman of its Board of Governors.

Professor van Hoorn has also distinguished himself with the Bureau's sister organization, the International Fiscal Association (IFA). As a member of the Permanent Scientific Committee, often as General Reporter, and as chairman of various panels at the annual congresses of IFA his impact on the tax world cannot be overestimated. It came as no surprise when Mr. Max Laxan, during the closing session of the 1985 London Congress of IFA, spoke in high praise of this executive of executives, scholar amongst scholars.

Professor van Hoorn's presence will continue to be felt, not only through his own efforts, but through the efforts of those he has instructed and worked with during his remarkable career. While he will no longer be at the Bureau, we hope he will remain available to any and all who seek his counsel. These past 40 years of service at the Bureau are of enduring impact and those of us who have had the pleasure of working with Professor van Hoorn are grateful for this opportunity.

When 1 December arrives and Professor van Hoorn is no longer giving daily support and guidance we will only be able to hope that the next era will be as golden. However, he has left a legacy that shall continue to grow and reflect his spirit for years to come.

In honor of Professor van Hoorn's contributions to the Bureau and various other publications, a bibliography has been compiled for easy reference and is printed in this issue.

Mr. Hamaekers Appointed Chief Executive of the International Bureau of Fiscal Documentation

Mr. H.M.A.L. Hamaekers

Mr. H.M.A.L. Hamaekers (42) has, as of 1 December 1985, succeeded Prof. J. van Hoorn Jr. as Chief Executive of the International Bureau of Fiscal Documentation.

In 1971 Mr. Hamaekers obtained his law degree (meester in de rechten) at the University of Nijmegen, the Netherlands. Thereafter, he pursued post-graduate studies in tax law at the University of Leiden.

During 1971-72 he was employed as a tax lawyer by a highly respected Dutch firm of chartered accountants. In 1973 he entered government service and from that year onward he has been employed in a number of functions as a civil servant by the Dutch Ministry of Finance, including a year of service in the Rotterdam Tax Office.

From 1975 to 1984 he was a member of the staff of the Directorate for International Fiscal Affairs of the Ministry, mostly being involved in multilateral tax matters. In this function he attended as delegate for the Netherlands meetings of the EEC (European Economic Community), GATT (General Agreement on Tariffs and Trade), OECD (Organization for Economic Co-operation and Development), UNESCO (United Nations Educational, Scientific and Cultural Organization), WIPO (World Intellectual Property Organization), INTELSAT (International Telecommunications Satellite Organization), and INMARSAT (International Maritime Satellite Organization).

During 1982-83 Mr. Hamaekers headed the Multilateral Affairs Division of the Directorate for International Fiscal Affairs of the Ministry and also acted as Chairman of the Working Party on the Taxation of Multinational Enterprises of the Committee on Fiscal Affairs of the OECD. Furthermore, he was the reporter on "The allocation of central management and service costs". Another report under his chairmanship is "Taxation of multinational banking enterprises". Both reports have become part of the OECD publication "Transfer pricing and multinational enterprises – Three taxation issues" (1984). In 1984 he was Chairman of the ad hoc group on unitary taxation (report on water's edge approach) of the OECD's Committee on Fiscal Affairs.

In 1984 Mr. Hamaekers was appointed Head of the VAT Legislation Section at the Ministry of Finance, and in 1985 Director, Deputy Head, at the Directorate Legislature – Indirect Taxes, at the same Ministry.

Mr. Hamaekers' career, during which he acquired a vast knowledge of direct and indirect taxation, and in particular of international tax problems, recommends him for the position of Chief Executive of the International Bureau of Fiscal Documentation. We are confident that he will be able to set a course comparable to his predecessors, Professor Dr. P.J.A. Adriani and Professor J. van Hoorn Jr., and maintain the Bureau's reputation as the center for information on international tax matters while expanding its activities in an ever changing (tax) world.

Mr. Hamaekers has contributed an article titled, "The OECD Report on the Allocation of Central Management and Service Costs", which is also printed in this issue.

The OECD Report on the Allocation of Central Management and Service Costs

By H.M.A.L. Hamaekers*

INTRODUCTION

The first attempt to give detailed international guidelines in the field of transfer pricing was made by the OECD and resulted in the 1979 Transfer Pricing Report.[1] The Transfer Pricing Report is related to Art. 9 (associated enterprises) of the OECD Model Convention[2] and to the OECD Guidelines for multinational enterprises of 1976. Art. 9 refers to profit adjustments by tax authorities in case of non arm's length conditions between associated enterprises.

The 1976 Guideline on taxation states that (associated) enterprises should refrain from making use of particular facilities available to them such as transfer pricing which does not conform to an arm's length standard.

The Guidelines and Art. 9 of the Model Convention, however, do not make clear what these arm's length standards are. The OECD Committee on Fiscal Affairs therefore entrusted the working party on taxation of multinational enterprises with the task of working out the arm's length principle in greater detail. The working party's mandate was to set out the factors to be taken into account in determining transfer prices for tax purposes, and to describe, where possible, generally agreed upon practices. The result of it was the 1979 Transfer Pricing Report.

This Report is meant to achieve consistency in the approaches of tax authorities on the one hand, and of multinational enterprises on the other in the determination of transfer prices. This should ensure correct profit taxation and avoid double taxation.

After its publication the Business and Industries Advisory Committee (BIAC) to the OECD welcomed the Transfer Pricing Report, but also raised several points of criticism especially with respect to Chapter IV, which deals with intra-group services. For instance, they expressed the view that the Chapter was rather vague, that it interprets shareholder costs too broadly and that the so-called benefit test may create problems when applied to global apportionment methods.

It was not very surprising that BIAC found the Transfer Pricing Report rather vague on central costs. It is very difficult to give guidelines for arm's length pricing in this category beause central costs are typical for MNEs and comparisons with non-associated situations can in many cases not be made.

In order to meet BIAC's criticism as far as possible the Committee on Fiscal Affairs of the OECD mandated the working party on taxation of multinational enterprises to prepare a specific report on central management and service costs. That report was adopted by the OECD Council in June 1984 and published in one volume with two other reports covering the field of transfer pricing (hereinafter cited as the "Report").[3]

CONTENTS OF THE REPORT

The problem described

The introductory chapter of the Report explains the nature of the problem. It also states that many of the considerations set out in the report may be relevant to research and development (R & D) costs, which are indeed in many cases incurred centrally for the benefit of various group members.

The problem is to determine which part of the total costs incurred by the parent company or group service center should be passed on to other group members, many of them being established in other countries. The criterion in this matter is: who benefits from the activities concerned? Related problems are the allocation method and the inclusion of a profit margin.

The Multinational Enterprise (MNE) runs the risk of economic double taxation because the tax inspector competent for the parent company in country A may be keen on costs deducted that should be passed on to group members in other countries, whereas his foreign colleague may be inclined to scrutinize costs charged to the group member for which he is competent. The latter may be inclined to apply a rather strict benefit test. The result may be that costs are neither deductible in country A nor in country B. On the other hand, tax authorities who are less strict in applying the benefit test run the risk of accepting the part of central costs that stricter colleagues abroad rightly or wrongly refused to accept. So for MNEs as well as for tax authorities it is important that clear international guidelines are set in this respect.

Response to BIAC's comments on the Transfer Pricing Report

Chapter I deals with the points BIAC raised on central costs after the publication of the 1979 report. The most important points of criticism relate to the scope of

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* Chief executive of the International Bureau of Fiscal Documentation.

[1] *Transfer pricing and multinational enterprises*, OECD, Paris (1979).

[2] *Model double taxation convention on income and capital*, OECD, Paris (1977).

[3] *Transfer pricing and multinational enterprises – three taxation issues* (Transfer pricing, corresponding adjustments and the mutual agreement procedure. The taxation of multinational enterprises. The allocation of central management and service costs), OECD, Paris, 1984.

shareholder costs and the application of the so-called benefit test. These issues are considered in more detail in Chapter II of the Report

An important consideration in paragraph 20 of the Report is that unnecessary trouble for MNEs may be avoided if the tax authorities of one country, for instance, the authorities competent for the parent company or the group service center, would certify that the expenses reported as incurred by the relevant taxpayer have been examined and found acceptable. This may be helpful for both the MNE and the tax authorities of countries where other group members are located. In paragraph 73 of the Report this consideration is repeated and made relevant for the allocation method applied.

Classification and allocation problems

Chapter II is the heart of the Report. The introduction divides centrally performed activities into three groups:
- activities of the parent company acting as a shareholder;
- activities performed for the benefit of specific group members;
- activities which may benefit to varying degrees the parent or service center, the group as a whole, or one or more group members.

One problem is the distinction of shareholders' activities – the costs thereof to be borne by the parent company – from other activities; another problem is the application of the benefit test.

Shareholder costs

Subchapter B deals with the scope of shareholder costs. It repeats the definition included in the Transfer Pricing Report that shareholder costs are costs related to managing and protecting (monitoring) the investments made by the parent company. In addition, paragraph 35 of the Report gives the important consideration that shareholder costs should be distinguished from costs which are incurred to render the conglomerate more profitable than the total of various individual parts would be if not related.

The distinction is clarified by two examples giving extreme situations. Example 1 is a loose-structure conglomerate wherein the group members are highly independent. Example 2 is a highly centralized conglomerate with many centrally provided managerial and other services, not provided in the situation of example 1. These additional activities in example 2, compared with example 1, give rise to extra profits which accrue primarily to the subsidiaries and only indirectly – in the form of dividends or an increased value of the participations – to the parent. Costs of activities of the parent that enhance the profit-making capacity of the other group members should, therefore, be allocated and charged to the other group members.

This is the majority view indicated in paragraph 37 of the Report as the first approach. In this approach shareholder costs, to be borne by the parent company, generally include the following categories:
- costs of activities relating to the juridical structure of the parent itself (costs of shareholders' meetings, of the supervisory board, of issuing shares in the parent);
- costs relating to reporting requirements of the parent, including consolidation of reports;
- costs of raising funds for the acquisition of participations including interest;
- costs of monitoring activities with respect to the investment as such in participations.

If the latter activities are intertwined with managing, control and coordinating activities, meant to improve the operation of the joint group members, the total costs of persons and departments concerned may be split according to an estimate of the time spent for the different purposes.

The second approach, indicated in paragraph 41, lays emphasis on the juridical independence of group members and does not take into account special circumstances of MNEs. In this approach a strict benefit test is applied on an annual basis. The country referred to in this context in paragraph 42[4] of the Report may, however, have changed its position, having meanwhile introduced tax facilities for so-called coordination centers, which may mean that the country now recognizes the special situation of MNEs.

Allocation methods / benefit question

Subchapter C discusses various allocation methods:
- the direct charging method;
- the cost-sharing method, based on an estimate of the share of the group member in the benefits arising from the activities;
- the cost funding and fixed key methods: the amount of the remuneration is related to the turnover or some other broad aspect of the enterprise concerned;
- the mark-up method, which means the inclusion of a fee in the price of products sold to a group member that incurs the central costs.

The Report expresses a preference for the direct method and states that, if specific services are rendered not only to affiliates but also to third parties, then also in the case of the affiliates direct charging would be required (except when services to third parties are merely occasional or marginal). According to the Report, the benefit question will not normally arise under a direct charging system if the services are actually rendered. The Report doubts whether tax authorities have legal power to insist on the application of the direct method.

In many cases the direct method cannot be applied. Two basic situations are:
- the value of the benefit cannot be quantified, except on an estimated basis;

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[4] The report does not explicitly mention countries which take minority positions. In this case, obviously Belgium is meant.

- complete recording and analysis of the relevant activities are disproportionately burdensome.

The Report recognizes as the most appropriate indirect method the cost sharing method because that method is based on an estimated benefit and actual costs. Tax authorities should not reject indirect methods for the mere reason that they are not, or seldom, applied between unrelated parties. They should take account, according to the Report, of the special circumstances of MNEs.

However – so states the Report – to make cost-sharing or cost-funding arrangements acceptable the following principles should be observed:
- clearly formulated, binding contracts, concluded in advance;
- to be observed consistently over several years;
- to be applied to all group members which will or may benefit from the activities, from an ex ante point of view;
- costs are to be determined on the basis of generally acceptable accounting principles;
- the group members which share the costs should have full access to the services concerned;
- costs chargeable to group members should be reduced by payments received from third parties (when exceptionally, the remuneration from third parties cannot satisfactorily be used as the basis for direct charging);
- no duplication of payment for the services concerned;
- alterations in activities or responsibilities of group members which influence their benefit position should be taken into account in the contracts as soon as possible.

The list is not meant to be exhaustive.

From these principles the conclusion should be drawn that indirect methods which have no relation with the actual costs incurred nor with the actual or expected benefit (for instance, cost funding or fixed key methods based on gross turnover, without any correction afterwards based on actual costs) are unacceptable.

In paragraph 68, advance rulings on the acceptability of contracts are recommended (the less controversial term "advanced guidance" is used!). This, together with the certificate ex post of paragraph 20 of the Report may be very helpful for MNEs to avoid uncertainty and lengthy discussions with tax authorities of the various OECD countries where they operate.

The attitude of tax authorities with respect to allocation methods, at least before the adoption of the Report, varies from country to country. According to the Report, two countries, which may be Belgium and Greece, are reluctant in accepting indirect methods. Other countries have more or less a preference for the direct method, but accept indirect methods under the aforementioned conditions. The tax authorities of one country (which may be Switzerland), however, give, from a practical and economic viewpoint, no priority to the direct method.

Amount of remuneration

The amount of remuneration is the subject of Chapter III. From this the two following questions arise:
- in the case of direct charging, whether a price based on the open market value should be used, and if not, whether the then applicable cost-oriented method should include a profit element;
- in cases where only an indirect method can be used, whether or not the charge should include a profit mark-up.

The general principle is that the prices for the services performed should be those paid between unrelated parties. If no comparable open market price can be determined, then the charge should include all relevant costs and an appropriate profit element.

The arm's length principle implies also that when the relevant service is usually performed between unrelated parties on a cost-price basis, a profit mark-up need not be applied between associated enterprises.

In paragraph 78 three cases are given in which a profit mark-up is always appropriate:
- the provision of such services is a main activity of the enterprise concerned;
- the enterprise is particularly capable of supplying such service and the value-cost ratio for the recipient is very positive;
- the cost of the services concerned represents a substantial proportion of the expenses of the recipient's business.

These cases are meant to indicate where, between nonrelated parties, a profit element is always included in the price of services.

If the direct method is used and an open market value can be determined, then the remuneration for the service concerned should generally be based on that value.

In paragraph 81 this principle is somewhat weakened by the consideration that one should take account of the special circumstances of the service department concerned.

If the situation cannot be compared with an independent service enterprise then a profit mark-up would not be appropriate (except in the cases mentioned in paragraph 78).

With respect to the profit mark-up the same principles apply to the direct method and to the individual methods. Paragraph 83 however indicates that – with respect to cost sharing methods – the third case mentioned in paragraph 78 (the value of the services represents a substantial proportion of the expenses of the services receiving company) does not apply if that would lead to unequal treatment of group members. The Report indicates that one country may never require a profit mark-up where indirect methods are employed. According to its administrative transfer pricing guidelines, this country must be Germany. It does not accept, nor require, a profit mark-up when the cost sharing method is applied. In Holland, however, the fee may include notional interest for the interest capital.

SIGNIFICANCE OF THE REPORT

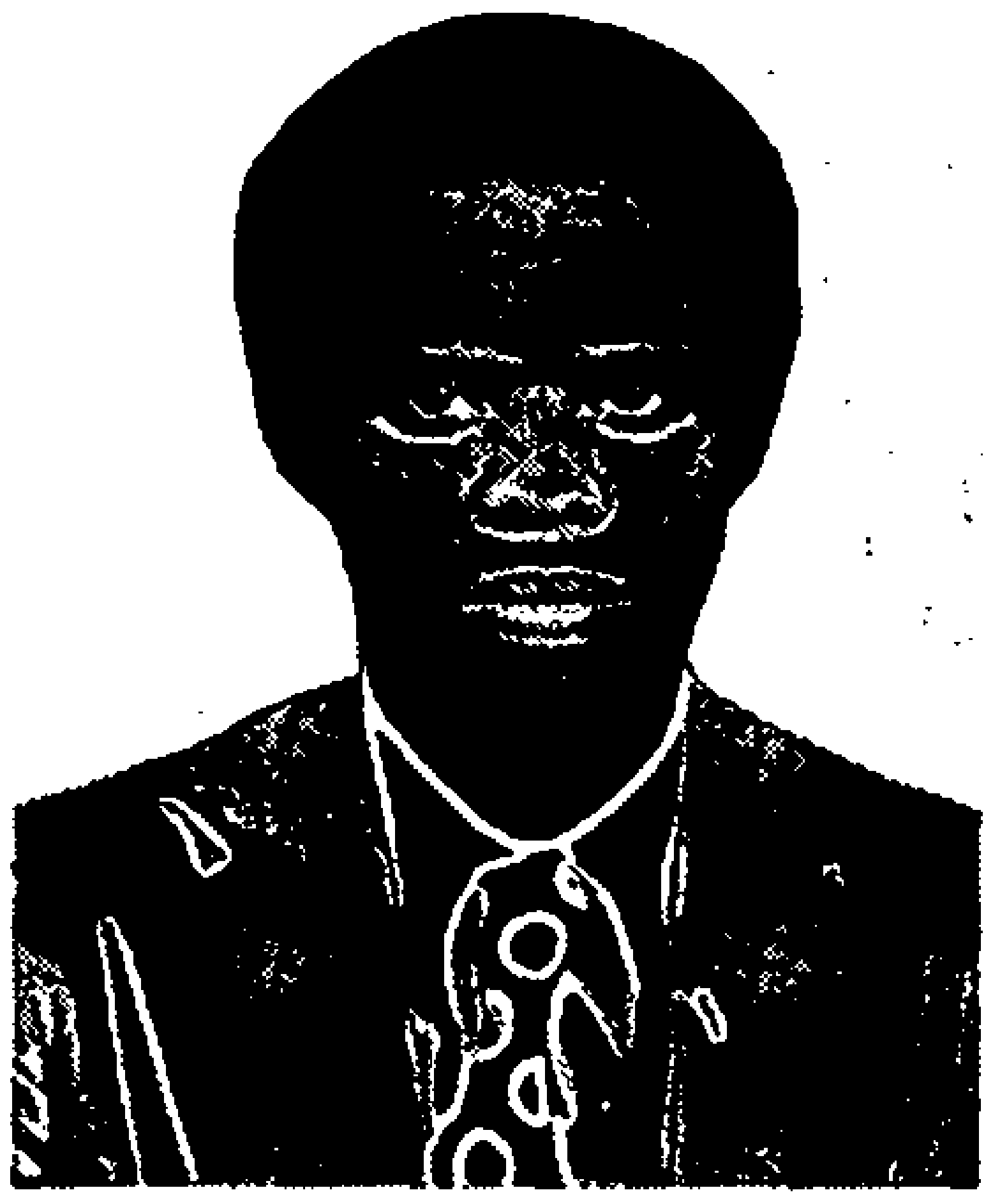
Although guidelines adopted by the OECD Council have no binding power they enjoy great influence over tax laws, conventions and practices of the Member States.

This has something to do with the fact that the tax reports adopted by the OECD are generally prepared by persons who are involved in the Member States with fiscal policy, with negotiations on tax conventions, with tax legislation or with the implementation of tax conventions and laws.

The significance of this Report may be that it gives a view of the almost unanimous position of the tax authorities of the OECD Member Countries concerning what they find acceptable as central costs to be allocated to group members, and the acceptable methods of allocation. This may lead to a convergence of national regulations and may avoid – especially in the case of countries which have not yet worked out detailed rules in this field – the adoption of new, deviating regulations.

The Report does not pretend to solve all problems. Therefore, in various paragraphs more explicit provisions in tax conventions, specific agreements between tax authorities in a follow-up to simultaneous tax audits, and, in the last analysis, mutual agreement procedures are advised.

A more express provision which is not given in the Report, but may help to avoid uncertainty, could be added to the present text of Art. 9 (associated enterprises). It may state that cost sharing agreements for the allocation of central costs and R & D expenses are not, as such, contrary to the arm's length principle. This is meant to indicate that, even if such agreements would not exist between unrelated parties, they may be in agreement with the arm's length principle.



NIGERIA:

Crucial Amendments to Income Tax Laws

By A.C. Ezejelue

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I. INTRODUCTION

A new tax law[1] was brought into existence in Nigeria on 21 March 1985, but with retrospective effect to 1 January 1985. The new Decree brought certain amendments to the two main income tax laws, viz. the Income Tax Management Act 1961 (ITMA) as amended and the Companies Income Tax Act 1979 (CITA) as amended. The ITMA[2] regulates the taxation of incomes of individuals, communities, families, trustees, executors and partnerships throughout Nigeria. The CITA,[3] on the other hand, imposes tax upon the profits of any company in Nigeria. In each case[4] the tax shall be payable upon income accruing in, derived from, brought into, or received in Nigeria. The relevant tax authority for an individual for any year of assessment, under the ITMA, is the tax authority of the territory in which the individual is deemed to be a resident for that year. But the tax authority under the CITA is the Federal Board of Inland Revenue, irrespective of where the company is located.

The purpose of this paper is to highlight some of the main amendments introduced into the income taxation of both persons and companies by the new Decree. The changes will be considered from two perspectives, namely, the ITMA as it affects individuals and the CITA as it affects companies. Where an amendment similarly affects both the ITMA and the CITA, a cross-reference will be made to that effect while discussing it under one or the other.

II. AMENDMENTS IN RESPECT OF ITMA

Some of the major amendments affecting the ITMA, and in some cases the CITA, are discussed below.

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[1] The Finance (Miscellaneous Tax Provisions) Decree No. 4 (1985). Hereinafter cited as "Decree No. 4, 1985".

[2] See section 3 of ITMA 1961 as amended.

[3] See section 8 of CITA 1979 as amended.

[4] See section 4(1) of ITMA 1961 and section 8(1) of CITA 1979.

A. Interest on money borrowed abroad

Under section 11 of ITMA, there were certain conditions under which income from any interest on money lent by an individual, or an executor, or a trustee, outside Nigeria to a person in Nigeria, either resident or present in Nigeria at the time of the loan, was deemed to be derived from Nigeria and, therefore, taxable.

These conditions include the fact that there existed a right to payment of the interest in Nigeria and that the interest was payable on money lodged at interest in Nigeria. In addition the interest must be, by deed, will or otherwise, charged upon or reserved out of real or personal property situated in Nigeria owned by the person paying the same, or arising from a personal debt or obligation by virtue of any contract which was entered into in Nigeria. And in the case of money lent to a Nigerian company, the loan must be evidenced by mortgage, debenture, loan or other stock, whether secured or unsecured, issued by the company in recognition of its debt. The import of these conditions was, to make the circumstances under which interest on such loans would attract Nigerian tax more difficult so as to make the lending transaction more attractive to the foreign lender.

These conditions have been totally abrogated by the new Decree and are not substituted by new conditions. Under the new Decree, the income from such interest shall be deemed to be derived from Nigeria and, therefore, subject to Nigerian tax if (a) there is a liability for payment in Nigeria of the interest regardless of what form the payment takes and wherever the payment is made, and (b) the interest accrues in Nigeria to a foreign company or person regardless of the way the interest may have accrued.[5] Under the new Decree, therefore, the possibility of such a loan has become more of an attractive source of revenue for the government than an attractive source of financing Nigerian businesses. The idea may be to discourage such foreign financing, which may involve foreign exchange in the repayment of principal and its servicing.

B. Personal allowance

In order to determine the chargeable income of an individual, section 20A of ITMA provides for certain allowances and reliefs to be granted to the individual. One of such allowances is the personal allowance granted to every individual who has an income subject to tax. Subsection 2 of section 20A of ITMA provided that, for every such individual, there should be a deduction allowed of ₦ 600, or one-tenth of the earned income of that individual, whichever was higher. This has been amended by the new Decree. The amendment is to the effect that "in the case of every individual, there shall be allowed a deduction of ₦ 1,200 plus 12½% of earned income in excess of ₦ 6,000".[6]

The importance of the amendment is that, (a) for any income of not more than ₦ 6,000 there is a flat rate allowance of ₦ 1,200, and (b) for any earned income[7] in excess of ₦ 6,000 there will be an additional allowance of 12½% to the flat rate allowance of ₦ 1,200.

This liberal free pay allowance is introduced as a stabilizing factor and a moderating force on the economy and business cycle. It is a device linking the tax system to economic stability. One of the ways in which economic stability can be achieved in a depression, during which there is a decline in taxpayers' spending power, is by reducing tax liabilities through liberal free pay allowances, exemptions and deductions.

C. Restriction on period for carry-forward of losses

In order to ascertain the total income of any individual for any year of assessment, section 21(2) of ITMA allows, inter alia, for the deduction of any loss reasonably incurred in any trade, business, etc. during any preceding year which has not been allowed against his assessable income of a preceding year. There is also a similar provision for companies in section 26(2)(a) of CITA. The new Decree has reintroduced a proviso[8] to both ITMA and CITA, i.e. that the period for carrying forward of any loss shall be limited to 4 years, after which period any such loss shall lapse.

The above proviso is reintroduced by the new Decree. The restriction was first introduced in 1976-77[9] and was reintroduced for the companies by Decree No. 98 of 1979.[10] The effect of the restriction will be to make individuals and companies endeavor to make profits in order to extinguish any unabsorbed loss from any particular trade. It will also make the continued fraudulent declaration of losses in any particular trade, business, etc. unattractive.

D. Air travel levy for journeys outside Africa

Section 10 of the new Decree introduced an entirely new section 21AA to the ITMA. With effect from 2 January 1985, any person making a journey by air outside Africa on a ticket paid for or payable in Naira shall pay an air travel levy of ₦ 100 per trip from Nigeria. This is a consumption tax on people who can afford to undertake such travels either for official, business, or pleasure purposes. The tax is also aimed at persons who draw on Nigeria's meager foreign exchange earnings by travelling outside Africa since Nigeria must find foreign currency for such journeys.

The persons exempted from paying the air travel levy include: (a) the head of the Federal Military Government; (b) the Chief of Staff, Supreme Headquarters; (c) the Governor of a State; (d) diplomatic, consular or United Nations' agency personnel who under any enactment or other arrangement is ordinarily exemp-

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[5] Decree No. 4, 1985, section 4.

[6] Ibid., section 8.

[7] Earned income includes income from employment (salaries, wages, etc.), trade, business, profession, or vocation. It does not ordinarily include such incomes as rents, dividends, royalties, interests, except if such incomes are deemed to be business or trading profit by a relevant tax authority.

[8] Decree No. 4, 1985, sections 9 and 25.

[9] See A.C. Ezejelue, "Nigeria: Tax considerations for investment and business decisions", 33 *Bulletin for International Fiscal Documentation* 8-9 (1979), at 398-409.

[10] See proviso (iii) to section 26(2)(a) of CITA 1979.

ted from paying taxes or other charges in Nigeria; (e) transit passengers whose tickets were purchased in a country outside Nigeria, even if such passengers are required to pay any surcharge or additional fare in Nigeria; (f) infants of not more than 2 years old; (g) such other persons as the Minister may by Order, published in the Gazette, from time to time, exempt from the provisions of this section.

E. Withholding tax on rents, dividends, interest and royalties

Under section 11 of the new Decree, new sections 21C, 21D, 21E, and 21F have been introduced into ITMA. The amendment introduced concerns withholding tax on rents, dividends, interest and royalties, as well as a penalty for failure to deduct such withholding tax. While section 21C deals with a withholding tax on rents, section 21D is on interest and royalties, and section 21E is on dividends. Each of the sections provides that a withholding tax of 15% is to be deducted at source by an authorized payer whenever such payments are made or credited to any beneficiary, whichever first occurs. The tax so deducted shall be paid over forthwith to the relevant tax authority. The authorized payers referred to in these sections are companies (incorporated or unincorporated), government ministries and departments, parastatals, statutory bodies, institutions, and other established organizations approved for the operation of the *Pay-as-you-earn* (PAYE) system, whether or not liable themselves to tax under any enactment or law relating to taxation of income in Nigeria or elsewhere. The new section 21F provides a penalty for failure to comply with sections 21C, 21D, and 21E.

The above amendments to ITMA are also similarly extended to CITA by the new Decree.[11] The corresponding amendments to CITA are provided in the new section 59 in respect of interest and royalties, new section 59A in respect of rents, new section 59B in respect to dividends, and new section 59D in respect of failure to comply with sections 59, 59A, 59B, and 59C. The only addition to CITA, not contained in ITMA, is in respect of the new section 59C, which provides that income tax assessable on any company, whether or not an assessment has been made, shall, if the Federal Board of Inland Revenue so directs, be recoverable from any payments made by any person to such company.

This is another form of deduction of tax at source, other than withholding tax at the rate of 15% as provided under the new sections 59, 59A, and 59B of CITA. The rate of tax applicable under section 59C is to be determined by the Board by reference to: (a) any assessable profits of that company for the year arising from any other source to income tax under the CITA; and (b) any income tax or arrears of tax payable by that company for any of the 6 preceding years of assessment.

The penalty for failure to deduct, or having deducted too little for payment to the relevant tax authority, within 30 days from the date the amount was deducted or the time the duty to deduct arose, shall on conviction be a fine of ₦ 5,000, in addition to the amount of tax deducted plus interest at the prevailing commercial rate. Where the beneficiary or recipient of such investment or other income is a company or corporate body, or a non-resident company or individual, or is an individual to whom the Armed Forces and Other Persons Special Income Tax Decree applies, the relevant tax authority for the remittance of the tax withheld is the Federal Board of Inland Revenue. Where the beneficiary is an individual resident in any state and liable to tax in that State, the relevant tax authority in that State receives the remittance. Remittances are to be accompanied with the necessary details, such as the gross amount of the payment, name and address of the beneficiary, and the amount of tax being accounted for, as prescribed in the new Decree. In order that such payments may be tax deductible, companies may be required to show evidence of the withholding tax deducted on such payments and paid over to the relevant tax authority.

The provisions of the new sections in respect of interest shall not apply to any person engaged in banking business in Nigeria. Banks are to continue with the existing practice of notifying relevant tax authorities of the names and addresses of recipients of interest on savings and deposits over ₦ 30. But, the interest which the banks themselves earn from their customers is part of the banks' profits and should not be regarded as interest for purposes of withholding tax.

F. Disclosure of information by banks

Under both section 28(3) of ITMA and section 42(1) of CITA banks are not required to disclose, for tax purposes, any information including name and address concerning depositors other than in respect of interest paid or credited to the customers (which in the case of an individual exceeded ₦ 30 in any period of twelve months).

The relevant provisions have now been amended by the new Decree[12] to the effect that banks are now obliged to disclose further information about their customers for tax purposes, provided that such a request is made in writing and is authorized by (a) the Chairman of the Federal Board of Inland Revenue in the case of companies, and (b) the Director of a State Internal Revenue Department of the relevant tax authority in the case of individuals. The new Decree further amends the provisions by introducing a new section 42(3) of CITA which prescribes a penalty for any bank that contravenes the new information disclosure requirements. It specifically imposes a fine of ₦ 5,000 in the case of a body corporate, and ₦ 500 in the case of an individual for contravention.

G. Tax clearance certificate

The new Decree[13] further amends ITMA by introducing a new section 33 and CITA by introducing a new

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[11] See Decree No. 4, 1985, sections 32 and 33.
[12] Ibid., sections 12 and 30.
[13] Ibid., sections 13 and 34.

section 74(a), both of which deal with tax clearance certificates (TCCs). Under the new provisions, for both the ITMA and the CITA, whenever a tax authority is of the opinion that tax assessed on income or profits of a person or a company has been fully paid or that no tax is due on such income or profits, it shall issue, within a reasonable time, a TCC to the person or company whenever such certificate is demanded by that person or company. A TCC which must be issued in a prescribed form and carry the appropriate authorization of the relevant tax authority shall disclose, in respect of the last 3 years of assessment: (a) total profits or chargeable income, (b) tax payable, (c) tax paid, and (d) tax outstanding or alternatively a statement to the effect that no tax is due. The Decree further provides that any ministry, department or agency of government, or any company, or any commercial bank with whom any person or company has any dealing with respect to any of the prescribed transactions[14] shall demand from such a person or company a TCC of 3 years immediately preceding the current year of assessment.

H. Capital allowances

For both the ITMA and the CITA, the new Decree[15] has provided a new method of computing "capital allowances" in relation to "annual allowances" (i.e. depreciation deductions). Up to and including the 1984 year of assessment, for both personal and company income tax purposes, annual allowances were computed on the written down value of the fixed assets at the end of the basis period for each year of assessment (declining balance depreciation).

This was without prejudice to an initial allowance, where applicable.[16] But, under the new Decree, the annual allowance will now be computed on a straight-line basis at the specified rate, after deducting the initial allowance where applicable – provided that an amount of ₦ 10 shall be retained in the accounts for tax purposes until the asset has been disposed. The total capital allowances that may be claimed in any assessment year are restricted under the new Decree to a maximum of 75% of the profits in the case of manufacturing companies and 66⅔% in other cases. Any individual in the agro-allied industry shall not be affected by this restriction.[17]

For assets in respect of which some capital allowances have been granted before the commencement of the new Decree, the total number of years of assessment for which allowance must be made (including past and future years) must be equal to the number of years for which allowance is to be made on the new straight line method. Where the number of years for which allowance has already been granted is equal to or more than the appropriate number of years under the new straight line method, a single allowance for an amount which is ₦ 10 less than the residue shall be made.

The new rates of capital allowances, as provided under the new Decree in respect of both individuals and companies, are as follows:

Qualifying expenditure in respect of:	*Initial allowance rate %*	*Annual allowance rate %*
Buildings	5	10
Industrial buildings	15	10
Mining	20	10
Plant	20	10
Motor vehicles	20	25
Plantation	20	33⅓
Housing estate	20	10
Ranching and plantation	25	15

I. Abrogation of turnover tax of 2½%

Another amendment introduced by the new Decree which merits mention is the deletion of section 5A(1)(c) which dealt with the turnover tax of 2½% on persons in the building and construction industry introduced by Decree No. 61 of 1977.[18]

III. AMENDMENTS IN RESPECT OF CITA

The following few amendments introduced by the new Decree are in respect of CITA only:

A. Incentive scheme for export promotion

Section 18 of the new Decree has introduced new incentive to encourage companies manufacturing for export. It provides that interest payable on any loan granted by a bank on or after 1 April 1980 for the purpose of manufacturing goods for export shall be exempted from tax as follows:[19]

Repayment period including moratorium	*Grace period*	*Tax exemption allowed*
Above 7 years	Not less than 2 years	100%
5 – 7 years	Not less than 18 months	70%
2 – 4 years	Not less than 12 months	40%
Below 2 years	Nil	Nil

In order to qualify for this tax exemption the manufacturing company must present a certificate issued by the Nigerian Export Promotion Council stating that the level of export specified has been achieved by the com-

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[14] Such transactions include applications for: (a) government loan for industry or business; (b) registration of motor vehicles; (c) firearms license; (d) foreign exchange or exchange control permission to remit funds outside Nigeria; (e) award of contracts by Government and its agencies and registered companies; (f) trade license; (g) approval of building plans; (h) import or export license; (i) plot of land; (j) registration as a contractor; (k) distributorship; (l) stamping of guarantor's form for Nigerian passport; (m) registration of a limited liability company or of a business name (see sections 13(4) and 34(4) of Decree No. 4 of 1985).

[15] See Decree No. 4, 1985, sections 15 and 36.

[16] An initial allowance is a special depreciation deduction which may be taken in the year of acquisition of the assets.

[17] "An individual in the agro-allied industry" means a person who: (a) establishes or manages a plantation for the production of rubber, oil palm, cocoa, coffee, tea, and similar crops; (b) cultivates or produces cereal crops, tubers, fruits of all kind, cotton, beans, groundnuts, sheanuts, beniseed, vegetables, pineapples, bananas and plantains; (c) establishes or manages animal husbandry, i.e. poultry, piggery, cattle rearing, fish farming, (d) engages in food production. (See section 15 of Decree No. 4 of 1985).

[18] See section 2 of Decree No. 4 of 1985.

[19] See Table II of Schedule 3 to CITA 1979. Before this amendment this table applied only to "Exemption on interest on loan by Banks granted for the purposes of an agricultural trade or business" section 9(7) of CITA 1979.

pany. In addition, the certificate must certify that not less than 50% of the goods manufactured and disposed of by the company in its fiscal year were sold outside Nigeria and were not reexported to Nigeria. This incentive scheme is effected by introducing a new subsection 9 of section 9 in the CITA.

B. Deductions not allowed

Section 22 of CITA specifies the expenses that are not tax deductible for the purpose of ascertaining the profits of any company. It has been amended by section 23 of the new Decree by substituting paragraphs (g) and (h) of it with new paragraphs (g), (h) and (i) which deal with expenses incurred within or outside Nigeria in respect of management fees and other expenses incurred outside Nigeria. These new provisions, which are deemed effective from 1 April 1979, specifically state as follows:

(g) Any expense of any description incurred within or outside Nigeria for the purpose of earning management fee unless prior approval of an agreement giving rise to such management fee has been obtained from the Minister.

(h) Any expense whatsoever incurred within or outside Nigeria as management fee under any agreement entered into after the commencement of this paragraph except to the extent as the Minister may allow.

(i) Any expense of any description incurred outside Nigeria for and on behalf of any company except of a nature and to the extent as the Board may consider allowable.

The effect of this amendment is to disallow, for tax purposes, (i) any expense in respect of management fee which has not the approval of the Minister of Finance, and (ii) any expense incurred outside Nigeria except when the Board of Inland Revenue specifically considers it allowable.

C. Pre-operational levy

Section 28 of CITA is amended by section 27 of the new Decree by substituting the former's subsection (4) by a new subsection (4) which introduces a pre-operational levy of ₦ 500 for each year of assessment or part thereof for which a company remains dormant after six months of being incorporated, but before submitting accounts for he first 12 or 18 months of operation. The provisions of Parts VII to XIII of CITA dealing with chargeability to tax, returns, assessments, appeals, collection, recovery, repayment, offenses, penalties, etc., shall apply to the new subsection on pre-operational levy.

D. Company income tax to be paid before dividends are paid to shareholders

The new Decree[20] amends section 30 of CITA by substituting its former subsection (7) with a new subsection which makes it mandatory for companies to pay income taxes before paying dividends to their shareholders. It provides that where a company declares a dividend, either interim or final, such dividend can only be paid to shareholders if the company's income tax on the total profit out of which the dividend is declared has been fully paid at the prescribed rate in section 28(1) of CITA to the Federal Board of Inland Revenue. The implication is that even where the final accounts of the company have not been agreed upon, as in the case of interim dividend, any profit declared as dividend becomes taxable, and such tax must be settled before the dividend is distributed to the shareholders. However, where any provisional tax has been paid by the company under section 58(1) of CITA, such tax shall be taken into account in determining the amount of tax due under the new subsection under review.

E. Profits of a company from certain dividends

Section 15 of CITA provides the methods of computing profits for 3 categories of companies from a dividend received from another company. The 3 categories of companies are: (a) Nigerian companies, (b) companies liable to pay Commonwealth income tax under section 32 of CITA, and (c) companies resident in a country which has a double taxation treaty, under sections 33 and 34 of CITA, with Nigeria.

The new Decree introduces a new proviso to section 15, applicable to the 3 categories of companies. The proviso is to the effect that a dividend distributed:

(i) by a Nigerian company and satisfied by the issue of shares of the company paying the dividend; or

(ii) if the company is a Nigerian company, out of any profits exempted from tax by any provision of CITA, or of the Industrial Development (Income Tax Relief) Act 1971; or

(iii) if the company is chargeable to tax under the provision of the Petroleum Profits Tax Act 1959 out of any profits to which section 51 of that Act applies, shall be excluded from the profits of any other company which is a shareholder in such company.[21]

Section 16 of CITA dealing with Nigerian dividends received by companies other than Nigerian companies has also been amended by section 21 of the new Decree. The amendment applies to a company which is neither a Nigerian company nor is engaged in a trade or business in Nigeria at any time during a year of assessment. For such a company, where the dividend is paid out of profits which have not been subjected to tax, whether the recipient of the dividend is a Nigerian company or not, the company paying the individual shall be charged a tax at the current rate under section 28(1) of CITA as if such dividend is the total profit of the company for the year of assessment which relates to accounts out of which the dividend is cleared.

F. Definition of year of assessment

The former definition of "year of assessment" under section 78(1) of CITA, as "a period of twelve months

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[20] Section 27 of Decree No. 4 of 1985.

[21] Ibid., section 20.

commencing on 1st April" is now amended to "a period of twelve months commencing on 1 January".[22]

In view of this amendment which took effect from 1 January 1980, the new Decree introduced new provisions[23] to section 24(1) and section 24(3)(d) dealing with the basis of computing assessable profits to take care of the effect of the transition.

The amendment specifies the basis period for the determination of assessable profits for the 1980 and 1981 years of assessment, in respect of companies which made up their accounts on any date between 1 January and 31 March 1980.

IV. CONCLUSION

The paper has focussed on the amendments to Nigeria's major tax laws, the ITMA and the CITA, brought about by the Finance (Miscellaneous Taxation Provisions) Decree 4 (1985) which came into force on 1 January 1985. The amendments discussed above are by no means exhaustive. There are some minor ones which were deliberately omitted from discussion. Also omitted are some amendments which were not considered to have far-reaching effects. These include the amendments affecting sections 9(1) and 20 of ITMA and sections 8(1)(g) and 14 of CITA.

Some of the amendments discussed have serious effects on the tax laws affected. It is hoped that highlighting these amendments will be of interest, not only to Nigerians and Nigerian companies, but also to foreigners and non-Nigerian companies that must, of necessity, consider the after-tax effects of their employment, investment and business decisions in Nigeria.

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[22] Ibid., section 35.

[23] Ibid., section 20. Similar provisions are introduced under section 20(1) and (4) of ITMA.

Conference Diary

JANUARY 1986

British Branch of I.F.A.: Current developments and proposed changes in U.S. taxation. London (United Kingdom), 14 January (English).

Internationales Steuerseminar Zürich: (International Tax Seminar Zurich). St. Moritz (Switzerland), 13-17 January (German).

European Study Conferences Limited: Tax planning for groups of companies. London (United Kingdom), 16 January (English).

Zentrum für Unternehmungsführung: Steuertagung Schweiz-Deutschland 1986 (Seminar). Zürich (Switzerland), 20-21 January (German).

European Study Conferences Limited: VAT – Living with Keith. London (United Kingdom), 21 January (English).

Zentrum für Unternehmungsführung: How to establish and manage a U.S. subsidiary. Interlaken (Switzerland), 27-29 January (German).

FEBRUARY 1986

Dr. Peter Deubner Verlag Gmbh: Tax seminar (including: new trends in tax case law, tax incentives for investments). Adelboden (Switzerland), 3-7 February (German).

European Study Conferences Limited: Double tax relief for corporate activity and ownership (including: tax-sparing provisions, tax treaties and anti-avoidance legislation). Zurich (Switzerland), 20 and 21 February (English).

MARCH 1986

International Tax Planning Association: Gibraltar Seminar (including: Gibraltar as a financial centre: Gibraltar as a base for international insurance; foreign investment in Spain). Gibraltar, 13-14 March (English).

APRIL 1986

European Study Conferences Limited: Share schemes – U.K. practice after the 1986 Budget. London (United Kingdom), 8 April (English).

European Study Conferences Limited: VAT: dramatic changes and perpetual oversight. London (United Kingdom), 22 April (English).

MAY 1986

International Tax Planning Association: Annual Conference (including: the RA/NDA: U.S. tax planning for the non-domiciled resident alien; minimising FIRPTA tax on dispositions of U.S. real estate). Santa Fe (U.S.A.), 19-21 May (English).

SEPTEMBER 1986

40th Annual Congress of I.F.A.: I. Transfer of assets into and out of taxing jurisdiction. II. Currency fluctuations and international double taxation. New York (U.S.A.), 7-12 September (English, French, German, Spanish).

FOR FURTHER INFORMATION
PLEASE WRITE TO:

British Branch of I.F.A., P.O. Box 68, Unilever House, Blackfriars, London EC 4P 4BY, United Kingdom.

Dr. Peter Deubner Verlag GmbH, Abteilung Seminar, Postfach 410268, 5000 Köln 41, German Federal Republic.

European Study Conferences Limited, Kirby House, 31 High Street East, Uppingham, Rutland, Leics LE 15 9PY, 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.

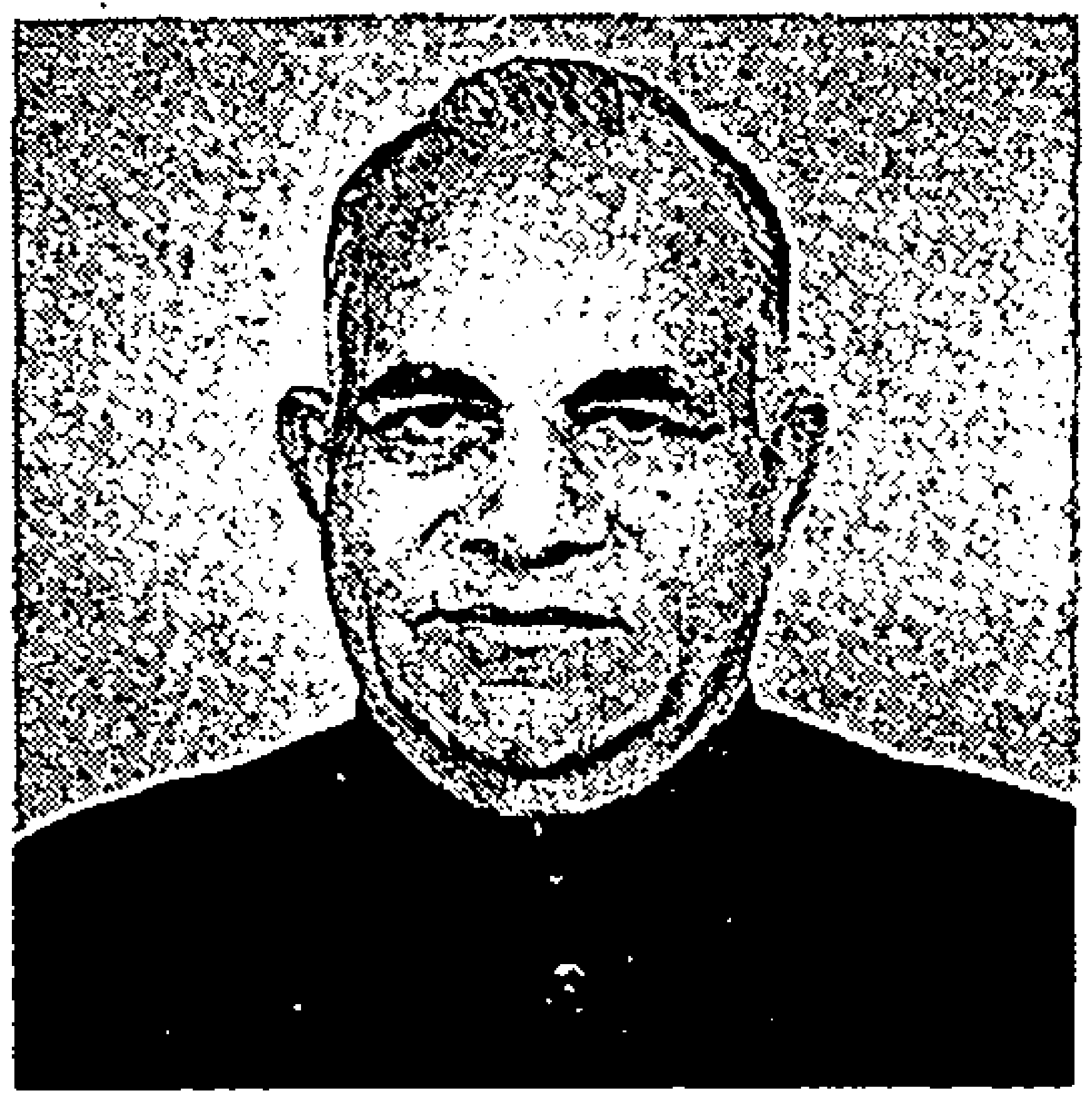
Internationales Steuerseminar Zürich, c/o Bank Leu, Bahnhofstr. 32 Zürich, Switzerland.

Zentrum für Unternehmungsführung, Schulstrasse 7, 8802 Kilchberg, Switzerland.

INDIA:

The Doctrine of Merger in Appellate Procedures Concerning Direct Taxes

By Har Govind



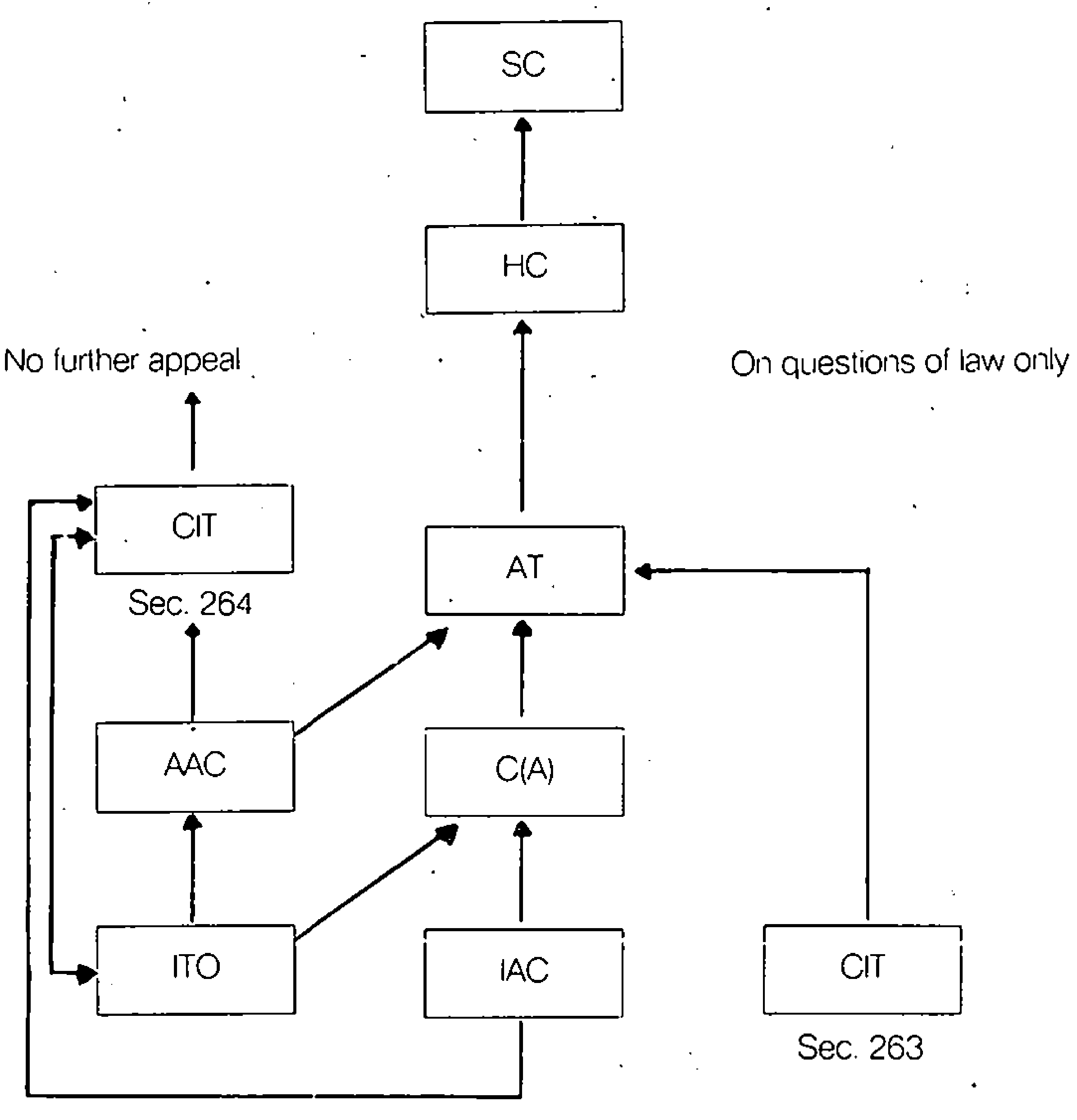
Mr. Har Govind, M.Sc.B.L., currently practises as an advocate in India. His former functions include: Chief Commissioner of Income Tax (Delhi), Member of the Income Tax Appellate Tribunal Competent Authority for Forfeiture of Smugglers' Property and Director (Investigation) Monopolies and Restrictive Trade Practices Commission.

Presently, four important direct taxes are being administered in India; the Income-tax Act 1961, the Companies (Profits) Surtax Act 1964, the Wealth-tax Act 1957 and the Gift-tax Act 1958. The levying of Estate Duty has been discontinued in respect of a person dying on or after 16 March 1985. The Appellate machinery under the four existing Direct Tax Laws is similar. Before commencing the discussion on "The Doctrine of Merger in Appellate Procedures", it is necessary to recapitulate, in brief, the present structure of the appellate system. An excellent paper on this subject from a historical perspective by Mr. Anil Kumar Jain was published in this Journal in 1973. In the past 12 years about half a dozen major changes have taken place in the relevant legislation. These are:

(i) Withdrawal of power of the Income Tax Officer (ITO) to re-open ex parte assessments.
(ii) Emergence of a senior assessing authority.
(iii) Creation of a new Appellate Authority, Commissioner (Appeals) (C(A)).
(iv) Enhancement of the fee for filing an appeal before the Appellate Tribunal (AT).
(v) Special provision for avoiding repetitive appeals.
(vi) Evolution of case law.

This study is confined mainly to the provisions of the Income-tax Act (IT Act). It applies, mutatis mutandis, to the other Direct Tax Acts. It incorporates the latest updates to the law as of 1 April 1985, including judge-made law, i.e., law laid down in decisions by the High Courts (HC) and the Supreme Court (SC). Under the IT Act there are five appellate authorities, namely; Appellate Assistant Commissioner (AAC), Commissioner (Appeals), Appellate Tribunal, High Courts and the Supreme Court. India is a union of 22 States and 9 union territories. Basically, there is one HC for each State and adjoining smaller states or union territory. There is a single Supreme Court for the whole country.

In addition, the Commissioner of Income Tax (CIT) has been vested with the power to revise certain orders. Under section 263 he can enhance or modify an order passed by the ITO or the Inspecting Assistant Commissioner (IAC) which is prejudicial to revenue. Under section 264 he has the power to grant relief to the taxpayer. The diagram indicates in ascending order the various appellate authorities.



WITHDRAWAL OF POWER OF THE ITO TO RE-OPEN EX PARTE ASSESSMENT

Under section 144 of the IT Act, the ITO has the authority to make an ex parte assessment according to his best judgement, if the taxpayer fails to file a return on his income or after filing the return, fails to comply with the statutory notices issued by the ITO requesting further, relevant information. Prior to 1 October 1984 the ITO was empowered to cancel such ex parte or best judgement assessments made by him if he was satisfied, upon application being made by the assessee under section 146, that the assessee was prevented from filing the income return or that he did not receive the statutory notes or he did not have a reasonable opportunity to comply or that he was prevented from complying with said notices. Per the Taxation Laws (Amendment) Act 1984, the provisions of section 146 relating to re-opening of ex parte assessments made after 30 September 1984 have been discontinued. This means ITOs will no longer be able to cancel or re-open ex parte or best judgement assessments they have made. This is a welcome reform which will help in cutting down delays. The taxpayer, however, does not lose any effective remedy. He will have the continued right, as before, to file an appeal with the AAC/C(A) or make an application for revision under section 264 of the IT Act to the CIT.

EMERGENCE OF SENIOR ASSESSING AUTHORITY

To handle complicated assessments and cases of comparatively larger taxpayers, a new section (125-A) was introduced in the IT Act effective 1 October 1975 by the Taxation Laws (Amendment) Act 1975. It empowers the CIT to confer concurrent jurisdiction over any area, persons or classes of persons, incomes (or classes of income), cases or classes of cases being reviewed by the IAC and the ITO. This section also authorizes the Commissioner to vest the IAC with powers to perform the functions of the ITO. In practice the provisions relating to concurrent jurisdiction are not utilised. A large number of IACs are now independently performing the functions of ITOs as senior assessing authorities. Provisions relating to the powers and functions of the ITO apply to IACs with the necessary changes. However, there is one major change. As the IAC is the income tax authority of the same rank as the AAC, a first appeal against orders issued by the IAC must be presented to the new appellate authority, the Commissioner (Appeals).

FIRST APPEAL

An assessee aggrieved by any of the specified orders of an assessing authority may appeal to the AAC or C(A) as the case may be. The jurisdiction of the AAC and the C(A) is well defined. Appeals from orders of the IAC and large, complex cases passed by the ITO are brought before the C(A). The jurisdiction of the C(A) is explained in detail in the next paragraph. Cases in which the appeal does not go directly to the C(A) are presented to the AAC. Almost the entire gamut of orders passed by the ITO and the IAC is appealable to the AAC or C(A). The first appeal is to be filed in the prescribed form and is to be verified in the prescribed manner. The AAC or C(A) shall have the following powers in disposing of an appeal:

(a) Against an order of assessment; he may confirm, reduce, enhance or annul the assessment, or he may set aside the assessment and refer the case back to the ITO for making a fresh assessment in accordance with the directions given.
(b) Against an order imposing a penalty: he may confirm or cancel such order or vary it so as either to enhance or reduce the penalty.
(c) In any other case he may pass such orders in appeal as he thinks fit.

NEW APPELLATE AUTHORITY

As already indicated, with the emergence of the senior assessing authority, the IAC, it has become necessary to dispose of appeals against orders which have been issued by referral to a superior income tax appellate authority. To meet this situation and to satisfactorily handle appeals involving important, complex questions of fact and law having substantial revenue implications, it was deemed desirable to have senior and more experienced appellate officers. Therefore, a new appellate authority, Commissioner (Appeal), was created by the Finance (No. 2) Act 1977, effective from 10 July 1978 for the purposes of the IT Act, the WT Act, the GT Act and the Surtax Act. An appeal may be brought before the C(A) against any of the following orders:

(a) Any order under section 104 of the IT Act relating to payment of additional income tax on undistributed profits by closely held companies.
(b) An order made by an IAC in exercise of his powers or functions as an assessing authority.
(c) An order made by the IAC imposing a fine under section 131(2).
(d) An order made in the case of foreign company, where the company denies its liability to be assessed under the IT Act, or any order of assessment under section 143(3) or section 144 of that Act wherein the assessee objects to the amount of income assessed or the amount of tax determined or the amount of loss computed or the status under which it is assessed.
(e) An order made in the case of a domestic company, when the domestic company denies its liability to be assessed under the IT Act or any order of assessment under section 143(3) or section 144 of that Act wherein the company objects to the amount of income assessed or the amount of tax determined or the amount of loss computed or the status under which it is assessed, provided that the amount of income assessed or the amount of loss computed exceeds Rs. 5 lakhs.
(f) An order of assessment made on the basis of directions issued by the IAC under section 144/B.
(g) An order imposing a penalty under section 271(1)(c) where the penalty has been imposed with the previous approval of the IAC under the proviso to clause (iii) of subsection (1) of that section.
(h) An order made by the IAC imposing a penalty under section 272A.
(i) An order made by an ITO under the provisions of the IT Act in the case of such persons or classes of person as the Board may direct, having regard to the nature of the case, the complexities involved and other relevant considerations.

It may be noted, though the AAC is an authority junior to the C(A), no appeal lies against the order of the AAC to the C(A). Second appeal against the AAC's order lies directly to the AT. The procedure for entertaining and disposal of appeals is the same for the C(A) and the AAC. Both also have the same powers in regard to discovery, production of evidence, calling for information and the inspection of registers.

Under section 119 of the IT Act there is a specific bar on the Central Board of Direct Taxes (CBDT) not to issue instructions that will interfere with the discretion of the AAC or C(A) in the exercise of their appellate functions.

APPEALS TO THE AT

For the second stage of appeals and Appellate Tribunal has been constituted under section 252 of the IT Act. This appellate body is not under the administrative control of the CBDT or the Ministry of Finance. It has been placed under the administrative control of the Ministry of Law and Justice. This gives it complete judicial independence. The following orders may be appealed to the AT:

(i) an order issued by an AAC;
(ii) an order issued by the C(A); and
(iii) an order issued by the CIT under section 263 revising an order of a subordinate authority prejudicial to revenue.

The right of appeal against the orders of the AAC and C(A) is given to both the assessee and the assessing authority. However, the assessing authority, the ITO or IAC, can file an appeal only if directed to so act by the CIT.

MEMORANDUM OF CROSS-OBJECTIONS

The assessing authority or the taxpayer, upon receipt of notice that an appeal against the order of the AAC or C(A) has been referred by the other party, may, notwithstanding that he may not have appealed against such order or any part thereof, file a memorandum of cross-objections under section 253(4). The filing of this memorandum of cross-objections is optional. The memorandum of cross-objections is to be disposed of by the AT along with the appeal.

PROCEDURE OF AT

The AT has to give both parties an opportunity to be heard. Thereafter it may issue such order on the appeal as it determines fit. The Tribunal has full power to dispose of appeals, including appeals involving questions pertaining to the valuation of assets. Previously, the AT was empowered to refer the question of valuation of assets for arbitration by two valuers (appraisers), one nominated by the appellant and one by the respondent. This procedure was found cumbersome and ineffective and has since been discontinued.

FEE FOR FILING APPEAL BEFORE THE AT

No fee is required of the assessee when filing the first appeal before the AAC or C(A). At the second stage of appeal both the IT Department and the assessee have the right to file an appeal with the AT. However, the Department pays no filing fee. An assessee filing an appeal against an order of the AAC, C(A) or the CIT under section 263, or filing a memorandum of cross-objections or application for statement of the case for reference to the High Court is required to pay a fee. This has been enhanced to Rs. 200 for each appeal, memorandum or application, effective as of 1 June 1981. Previously, the fee payable was only Rs. 125.

STATEMENT OF CASE TO HC

The assessee or the Commissioner, if aggrieved by the orders of the AT, may file an application under section 256 in the prescribed form to the AT for referral of any question of law arising out of the AT's order to the HC. The AT is required to dispose of such application within 120 days of its receipt.

It should be noted that the AT is the final fact finding authority. It can be requested only to state a question of law arising from its order and not any question of fact. If the AT refuses to state a question on the ground that no question of law arises, the assessee or the Commissioner may, within 6 months from the date on which he was served with a notice of such refusal, apply to the HC. If the HC is not satisfied with the correctness of the decision of the AT, it is empowered to direct the AT to state the case and refer the same for decision.

DIRECT STATEMENT OF THE CASE TO THE SC

If the AT is of the opinion the issue raised in an application made under section 256 has previously been answered in conflicting decisions of the HCs, and the AT is of the opinion it will expedite the case it may draw up a statement of the case and refer it through its President directly to the SC.

APPEAL TO THE SC

Any judgement of the HC, delivered as a result of a referral under section 256 in which the HC certifies the issue to be fit for appeal, may be brought before the Supreme Court. The appeal to the SC is to be filed in accordance with the Rules the SC has framed.

SPECIAL LEAVE TO APPEAL

If the HC declines to grant a certificate of fitness for appeal to the SC the assessee or the Commissioner may approach the SC under Article 136 of the Constitution of India for granting special leave to appeal.

Under this Article the SC may, in its discretion, grant special leave to appeal from any judgement, decree, determination, sentence or order in any case or matter passed or made by any court or Tribunal in the Territory of India. This original jurisdiction of the SC is very wide and is being used by many aggrieved parties and authorities.

DISPOSAL OF APPEALS BY HC AND SC

The HC or the SC upon hearing any appeal shall decide the questions of law raised therein and shall deliver a motivated judgement. A copy of the judgement shall be sent, under the seal of the Court and the signature of the Registrar, to the AT which shall pass such orders as are necessary to dispose of the case in conformance with the judgement.

REVISION BY COMMISSIONER SECTION 264

The power or the Commissioner to revise is in the nature of a mercy petition. In the case of any order issued by the ITO, IAC or AAC, the Commissioner may, either sua sponte or on application made by the assessee for revision, call for the record of any proceeding under this Act, and after making the requisite enquiry issue an order as he thinks fit. Of course, such an order should not be prejudicial to the assessee. However, if the CIT simply declines to intervene, such an order shall not be treated as prejudicial to the assessee. In the case of an application by the assessee it shall be accompanied by a fee of Rs. 25. The Commissioner has no authority under section 264 to revise orders in the following cases:

(a) where an appeal against an order is within the power of the AAC or C(A) or the AT, but has not been made and the time within which such appeal may be made has not expired;

(b) where the order has been made the subject of an appeal to the AAC, C(A) or AT.

The Commissioner (Appeals) is not subordinate to the CIT. His order cannot be revised by the Commissioner under section 264.

It is important to note that the order of revision by the Commissioner under section 264 is final. No appeal lies either on questions of law or of fact to any authority. An assessee can approach the Commissioner under section 264 directly from the ITO's order or after that order has been adjudicated by the AAC or direct from an order issued by an IAC. No right to petition for revision exists under section 264 after an IAC's order has been adjudicated by the C(A). Before having recourse to Section 264 the assessee should remember that no further avenue of appeal is available to him if an order under section 264 is issued by the Commissioner. As stated previously, this action is used mainly by assessees as a mercy petition when they do not have sufficient evidence or proper accounts to support their case or they have been unable to file an appeal with the AAC or the C(A) within the prescribed time.

TIME LIMIT FOR FILING APPEALS

The IT Act provides a time limit for the filing of appeals before the Appellate authorities and petitions for revision before the CIT. The following brief chart summarising the relevant time limits may be useful for ready reference:

Name of the Appellate Authority	*Limitation period*
AAC	Within 30 days from the date of service of notice for demand relating to assessment or levy of penalty or date of communication of order against which appeal is to be filed.
CA	As above.
CIT (under section 264)	One year from the date of order if revision is made by CIT sua sponte. If application is made by the assessee; one year from the date on which the order in question was communicated.
AT	
(i) Appeal	Within 60 days of the date on which the order to be appealed is communicated.
(ii) Memorandum of cross-objections	Within 30 days of the date of receipt of notice.
(iii) Application for statement of case	Within 60 days of the date of service of a copy of the AT's order.
HC	If AT refuses the application of the assessee or CIT to state a case before the HC either party may make an application to the HC within 6 months from the date of service of notice of refusal.
SC	90 days from the date of the HC's order.

The time consumed in obtaining a certified copy of the HC judgement shall be excluded in computing the period of 90 days.

All appellate authorities, the CIT, the HC and the SC have discretion to admit an appeal, memorandum, application or petition, even after the expiration of the limitation date, if sufficient cause can be shown by the appellant or the applicant for the tardiness.

AVOIDANCE OF REPETITIVE APPEALS

When there is a conflict between the ITO and a taxpayer on any question of law disputed for several years, the taxpayer must contest the question of law for each of these years. This leads to the unnecessary proliferation of appeals before the appellate authorities and reference applications before the HC on identical questions of law.

With a view to avoiding such repetitive appeals and reference applications the Taxation Laws (Amendment) Act 1984 has inserted a new section for avoidance of repetitive appeals. This new section (158A) provides a special procedure in cases where an assessee claims a question of law, arising in his case concerning an assessment year which is pending before the ITO or any appellate authority (such case being hereafter referred to as "the relevant case"), is identical with the question of law arising in his case for another assessment year which is pending before the HC on reference under section 256 or before the SC on reference under section 257 or in appeal under section 261 (such case being hereafter referred to as "the other case"). In such cases, the assessee may furnish the ITO or the appellate authority a declaration in the prescribed form and verified in the prescribed manner, that if the ITO or the appellate authority agrees to apply to the relevant case the final decision on the question of law in the other case, he shall not raise such question of law in the relevant case on appeal before any appellate authority or for a reference before the HC or the SC or in appeal before the SC under the aforesaid sections of the IT Act.

Where a declaration as aforesaid is furnished to any appellate authority, the appellate authority will have to call for a report from the ITO on the correctness of the claim made by the assessee. Where the ITO makes a request to the appellate authority to give him an opportunity to be heard in the matter, the appellate authority will have to allow such opportunity to the ITO.

The fact that the claim made by the assessee is admitted will not preclude the ITO or the appellate authority from making an order disposing of the relevant case without awaiting the final decision on the question of law in the other case. However, when the decision on the question of law in the other case becomes final, it shall be applied to the relevant case and the ITO or the appellate authority shall, if necessary, amend the order previously issued by the ITO or the appellate authority in conformance with the final decision on the question of law in the other case.

When a claim by the assessee is admitted, the assessee shall not be entitled to raise, in relation to the relevant case, that question of law on appeal before any appellate authority or for reference before the HC or the SC or on appeal before the SC under the aforesaid section of the IT Act.

POWER OF ENHANCEMENT

As already mentioned briefly, the AAC and C(A) have the power to enhance an assessment or penalty. The CIT also has the power under section 263 to revise any order passed by the ITO or IAC if it is prejudicial to revenue.

The AT, HC and SC have no power of enhancement. They can either grant relief or dismiss the appeal.

The power of enhancement conferred upon the AAC and the C(A) is not unlimited. It has been restricted by judicial decisions and applies only in certain specific circumstances. It is not open to the AAC or C(A) to travel outside the record, i.e., the return made by the assessee or the assessment order of the assessing authority with a view toward finding new sources of income. The power of enhancement under section 251 of the IT Act is restricted to the sources of income which have been made the subject matter of consideration by the ITO or the IAC, from the point of view of taxability. They are not authorized to consider any matter which was not raised or processed before the ITO or the IAC. This position is now clearly established in the SC's decision, *Additional CIT* vs. *Gurjar Gravures Pvt. Ltd.* (1978) 111 Income Tax Report (ITR), which follows the earlier decisions of the SC.

The power of enhancement of the AAC or the C(A) is further limited to the assessment order in question. It does not extend to any other assessment year. For example, while deciding an appeal for the 1985-86 assessment, if the AAC notices an under-assessment in the immediately preceding assessment year, 1984-85, he cannot order an enhancement for that year (*Rajinder Nath* vs. *CIT* (1979) 120 ITR 14 (SC)).

REVISION UNDER SECTION 263

Under section 263, the Commissioner may call for and examine the records of any preceding and revise the order of the ITO or IAC if he considers it to be erroneous in so far as it is prejudicial to revenue. It is noteworthy that the Commissioner, under section 263, has no power to revise an order issued by the AAC or the C(A). The rationale behind this is that, against the orders of the AAC and the C(A), he can always authorize an appeal to the AT whereas no departmental appeal is provided to the AAC or C(A) against an order issued by the ITO or the IAC.

The revision under section 263 is permissible within a period of 2 years from the end of the financial year in which the order sought to be revised was issued. This change has been in effect since 1 October 1984. Previously, the period of limitation was 2 years from the date of the order sought to be revised.

The assessee aggrieved by an order under section 263 is entitled to file an appeal directly to the AT.

DOCTRINE OF MERGER

As noted above, the Commissioner may call for and examine the record of any proceeding and revise, under section 263, the order of the ITO or the IAC if he considers it to be erroneous insofar as it is prejudicial to revenue. The question for examination is whether the Commissioner can revise an order of the ITO even if it has been the subject matter of an appeal to the AAC. There is a school of thought that on appeal the ITO's order merges with the appellate order of the AAC and, therefore, it would cease to exist and since section 263 only contemplates the revision of the order of an ITO that section would not be applicable. This problem would only exist in those cases where the order issued by the ITO is adverse to revenue and the particular point has not been considered by the AAC.

The reason being, if the point is covered by the decision of the AAC, the ITO's order would merge with the order of the AAC and the department would have the remedy of appeal against such order of the AAC before the AT.

In such circumstances it would obviously not be necessary to provide an additional remedy to the Commissioner to use his power of revision under section 263. Allowing another remedy for the same problem would be regarded as discriminatory, particularly as the assessee would be considered to be in a worse position if the Commissioner were to resort to the power of revision instead of adopting the procedure of directing the ITO to file an appeal.

JURIDICAL BASIS

The SC in its decision in *Messrs. Gojer Brothers* vs. *Rattan Lall Singh*, All India Reporter (AIR) (1974) SC 1380, has reviewed most of the relevant decisions of the court with regard to the doctrine of "merger". Explaining this doctrine, the highest court of the country has observed that the judgement of an inferior court, if subjected to an examination by the superior court, ceases to exist in the eyes of law. It is treated as being superseded by the judgement of the superior court, i.e., it merges with the judgement of the superior court. The justification for this doctrine of merger is based on the principle there cannot be, at one and the same time, more than one operative order governing the same subject matter.

WIDE SCOPE

A study of the decisions by the SC reveals that the doctrine of merger is applicable in several situations:

(i) When a government servant is dismissed by executive order (*Somnath v. Secretary to Government of Orissa* (1909) 3 SCC 384).

(ii) When the decision of the lower court has been summarily set aside (*U.S. Chopra v. State of Bombay* AIR (1955) SC 633).

(iii) When the order of the lower Tribunal is merely reviewed by the higher authority (*Gopal Rigta v. Secretary of Orissa* AIR (1962) SC 1513).

(iv) When the appeal is dismissed without any modification of the order of the original authority (*Collector of Customs v. East India Commercial Co. Ltd.* AIR (1963) SC 1124).

(v) When the order of the lower court has been the subject matter of review under the Civil Procedure Code (*Shankar Ramchandra Abhayankar v. K.D. Bapat* AIR (1970) SC 1).

DOCTRINE NOT RIGID

In the five cases mentioned above, the subject matter of the appellate order was the same as that of the lower court or Tribunal with the result that there was no difficulty in applying the principle of merger in these cases. But in the Gojer Brother's case referred to earlier, the SC has also accepted the principle that, in a case where the subject matter of the appellate order is not the same as that of the order of the lower court or Tribunal, application of the principle of merger may not be possible. In this connection it may be useful to study in detail the case of *State of Madras v. Madurai Mills Co. Ltd*, AIR (1967) SC 683, wherein it was held that the doctrine of merger was not a doctrine of rigid and universal application and it would not be said that wherever there were two orders, one by the lower court and the other by the superior court, issued on appeal or revision, there would be a fusion or merger of the two orders irrespective of the subject matter of the appellate or revisional order and the scope of appeal or revision contemplated by the particular statute. The SC has observed that the application of the doctrine of merger would depend on the nature of the appellate or revisional order in each case and the scope of the statutory provisions conferring the appellate or revisional jurisdiction. In the Madurai Mills case an order of assessment had been originally issued by the Deputy Commercial Tax Oficer on 20 November 1952. The assessee went on appeal to the Commercial Tax Officer on two counts and the latter upheld the assessee's contention on the second count. Accordingly, the Deputy Commercial Tax Officer revised the order of assessment in accordance with the decision of the Commercial Tax Officer. Later, the assessee filed a revision before the Deputy Commercial Tax Officer alleging that a sum of Rs. 657,971, which was an amount collected by it by way of tax, had been wrongly included in the turnover by the Deputy Commercial Tax Officer. This revision was rejected by the Deputy Commissioner of Commercial Taxes on 21 August 1954. Thereafter, the Board of Revenue issued a notice to the assessee to show cause why the sum of Rs. 77,462,706 should not be included in the turnover on the ground that it had been wrongly excluded by the assessing authority. The assessee objected to this. Firstly, on the ground that this has not been wrongly excluded, because it represented the value of the yarn purchased from outside the State of Madras which was exempted. And secondly, the Board's notice was time barred as being beyond 4 years from the date of the Deputy Commercial Tax Officer's order of 28 November 1952. The Board rejected these contentions by its order of 25 August 1953 issued in exercise of its revisional jurisdiction and included the sum of Rs. 77,462,706 in the turnover. The HC allowed the appeal of the assessee on the ground that the order of the Board dated 25 August 1953 was time barred. The SC upheld the contention of the assessee. It held that the original order of assessment issued by the Deputy Commercial Tax Officer on 28 November 1952 had not merged in the revisional order of 21 August 1954 issued by the Deputy Commissioner of Commercial Taxes because the question of exemption of the value of the yarn purchased from outside the State of Madras was not the subject matter of the revision before the Deputy Commissioner of Commercial Taxes. Therefore, the only effective order which was sought to be revised by the Board was the order of the Deputy Commercial Tax Officer of 28 November 1952 and as the same had not merged with the revisional order of 21 August 1954 it was clearly barred by the statute of limitation at the time when the Board issued its order of 25 August 1953. This decision clearly shows that unless the matters dealt with by the higher authority are the same as those dealt with by the lower authority, the doctrine of merger will not apply.

CIRCUMSTANCES NOT AMOUNTING TO MERGER

In certain circumstances, there will be no merger of the ITO's order with the appellate order of the Appellate Commissioner. This is evidenced by the decision of the SC in Amritlal Bhogilal's case, AIR 1958 SC 863 (1958) 34 ITR 130 (SC). In that case the assessee was a firm. The ITO had passed a composite order of assessment and also an order granting registration. An appeal was brought by the assessee to the AAC against the composite order of the ITO. The order of registration was in the assessee's favour and, naturally, there was no appeal by it with respect to the order of registration. The order of registration was found to be erroneous and was sought to be revised by the CIT. It was held by the HC that the order of the ITO granting registration to the respondent had merged with the appellate order and the revisional power of the CIT could not be exercised. The SC overruled the HC's view.

It held that the order of the ITO granting registration could not be deemed to have merged with the order of the AAC in an appeal brought against the composite order of assessment, because the order of registration could not be the subject matter of appeal before the AAC. The order of the ITO registering a firm could, in these circumstances, be revised by the Commissioner under section 33B of the Indian IT Act 1922, corresponding to section 263 of the 1961 Act, if he considers it has been erroneously issued and is prejudicial to revenue. He could revise it even when an appeal is pending from an order of assessment and even after the appeal had been disposed of by the AAC. This case is, therefore, authority for the view that the part of the ITO's order which could not be the subject matter of an appeal before the AAC could be revised by the Commissioner by means of his revisional powers under section 263 of the IT Act.

The doctrine of merger was also not applied by the Gujrat High Court in the case of *Karsandas Bhagwandas Patel v. G.V. Shah* (1975) 98 ITR 255 (Guj). In this case the ITO had, in the original assessment, allowed initial depreciation on motorcars and motorcycles. This allowance being favourable to the assessee was obviously not included in the grounds of appeal referred by the assessee to the AAC.

Also the AAC did not sua sponte consider and decide whether initial depreciation was correctly allowed. In a detailed and persuasive decision, the Gujarat High Court has held that the decision of the ITO allowing initial depreciation on motorcars and motorcycles did not merge with the order of the Assistant Commissioner and, therefore, the ITO was entitled to rectify this part of his order under section 35 of the 1922 Act, corresponding to section 154 of the 1961 Act, by adding back the amount of such initial depreciation. The HC has explained the scope of the power of the AAC. It has observed that his powers were not confined to the subject matter of the assessment. The entire assessment was thrown open before him and so long as he did not travel outside the matters considered and determined by the ITO he could correct the decision of the ITO made in the course of the assessment, even if the assessee was satisfied and had not challenged it on appeal. But a question arises as to what would be the position if no grievance was made by the assessee in respect of a particular item and the AAC did not choose to consider that particular item sua sponte. In such a case there would not be any decision of the AAC in regard to that particular item. Can it then be said that the decision of the ITO was superseded or replaced by the decision of the AAC insofar as that particular item is concerned? Answering this question, the HC observed it was true that the AAC could sua sponte revise the decision of the ITO in regard to that particular item, but so long he did not do so the decision of the ITO stood and there was no merger or fusion of it with the decision of the superior authority. If the AAC were under an obligation to examine the correctness of every decision recorded by the ITO in the process of an assessment it might be possible to contend that the AAC did not say anything about a particular decision recorded by the ITO and, therefore, he should be presumed to have assented and an inference of implied assent might be raised. However, it could not be disputed that, although the AAC undoubtedly had the power to revise any decison of the ITO sua sponte, as there was no obligation, there could be no scope for application of the doctrine of implied decision. Accordingly the HC held that there could be no merger of the ITO's order with the AAC's order in such a situation.

LATEST CASE LAW

The full Bench of the Karnataka High Court has analysed in its order of 1 April 1985, issued in the case of *Met-Chem Canada Inc.*, the particulars laid down by the SC in the case of *Amritlal Bhogilal* 34 ITR 130, *Shapoorji Pallonji* 44 ITR 891, *Rai Bahadur Hardut-tray Chamaria* 66 ITR 443, *Madurai Mills* 19 STC 144, and *Gojer Brothers* AIR (1974) SC 1380. It has observed that the doctrine of merger is based on the principle that there cannot be, at one and the same time, more than one operative order governing the same subject matter. When an appellate authority has in fact dealt with an issue in its order, such matters are covered by the doctrine of merger. Similarly if an appellate authority does not have jurisdiction under the law to deal with an issue, the doctrine of merger does not operate in respect to that issue. These are undisputed propositions.

The present controversy is in relation to the following issues:

(i) issues which could have been dealt with by the appellate authority within its jurisdiction, but in fact have not been dealt with by the said authority; and

(ii) issues which are in fact raised before the appellate authority, but not dealt with by the said authority.

On the above two controversial issues two groups of HCs have expressed contrary views. One view is that, since the entire subject matter of the assessment is within the jurisdiction of the AAC/C(A), the entire assessment is merged with the appellate order, irrespective of the points urged by the parties or decided by the AAC/C(A). This view is taken by the following High Courts:

Allahabad:	*JK Synthetics Ltd v. A.CIT* 105 ITR 344.
Patna:	*Commissioner of Commercial Taxes v. Rameshwardas Pannalal* 34 STC 296.
Calcutta:	*Jeevanlal v. A.CIT* 108 ITR 407.
M.P.:	*CIT v. Narpat singh Malkhan Singh* 128 ITR 77.
M.P.:	*CIT v. Mandsaur Electric Supply Co. Ltd.* 140 ITR 677 (F.B.).

A contrary view is taken by other High Courts, depending upon the subject matter of the appellate order. They have held that the part of the order of assessment which relates to items not forming the subject matter of the appellate order or, which is left untouched does not merge in the appellate order.

Gujrat:	*Karsandas Bhagwandas Patel v. ITO* 98 ITR 25.
Calcutta:	*Singo Mica Mining Co. Ltd. v. CIT*[1] 111 ITR 231.
Bombay:	*CIT v. Seksaria Cotton Mills Ltd.* 124 ITR 570.
Madras:	*Purushotam Estates Ltd. v. State of Tamil Nadu.* 125 ITR 41.
Punjab & Haryana:	*New Divan Oil Mills v. CIT* 129 ITR 224.

In view of these conflicting opinions, the full Bench of the Karnataka High Court has ultimately held that, in the case under appeal, the entire order merges when the order was taken on appeal and was modified by the AAC.

According to the HC such an order was final and the Commissioner was precluded from taking action under section 263. Thus, the Karnataka High Court has gone with the view expressed by the first group of HCs mentioned above. However, taking into consideration the conflicting views expressed by the various High Courts, the Karnataka High Court has granted leave to appeal to the SC. The Income Tax Department has filed an appeal to the SC. The result is being awaited with interest.

POSSIBILITY OF TAX REFORM

The appellate procedure studied in the preceding paragraphs is quite lengthy, time consuming and also confusing in certain areas. Many are of the opinion that it needs to be simplified in the following ways:

(i) The existence of two appellate authorities in the Income tax Department, the AAC and C(A), creates confusion, particularly for taxpayers who are not very familiar with the intricacies of the law. This often leads to the filing of appeals before the wrong authorities. The institution of the AAC should now be discontinued. All appeals from the orders of the ITO or IAC should be brought before the C(A).

(ii) The procedure of making an application to the AT to state a case for reference to the HC is cumbersome, time consuming and costly. The assessee and the CIT should have the right to file an appeal directly with the HC, without any statement of case by the AT.

(iii) There is a widely held opinion that the routing of the second and third appeals through the AT and the HCs causes considerable delay and involves avoidable expenditure. This also leads to conflicting decisions by different HCs. The remedy lies in eliminating the AT. The appeal from the order of the C(A) should go directly to a central tax court with benches at important centers. Thus, the central tax court will take the place of the various HCs. A final appeal may be made the order of the central tax court to the SC.

(iv) At present the HCs do not send copies of their orders to the appellant and the respondent. The aggrieved party has to obtain a certified copy of the HC's order for filing an appeal. This takes considerable time, sometimes years, before an appeal can be filed with the SC.

This procedure is outdated. The HCs must supply sua sponte an authenticated copy of their orders to both parties as soon as the order is delivered.

The discussion in the foregoing paragraphs shows that the "Doctrine of Merger in the Appellate Procedures" affords a valuable right to the taxpayer. This doctrine has been evolved by the Courts of Justice over the years. After the merger, the ITO's or IAC's order cannot be modified by the CIT to the disadvantage of the taxpayer. This doctrine is of wide application and is still in the process of evolution. Further light may be thrown on this doctrine after the decision is made in the case of the Canadian Company, Met-Chem, which is presently before the Supreme Court.

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[1] Decisions rendered by different branches may sometimes conflict. This was the case with the Calcutta HC.

BANGLADESH:

Some Highlights of the 1985-86 National Budget

By K.A. Gofran

The budget of the Government of the People's Republic of Bangladesh, for the fiscal year 1985-86, shows a revenue surplus of Tk. 441 crore, with an estimated revenue receipt of Tk. 3754 crore and an outlay of Tk. 3313 crore on Revenue Account. This surplus together with the new fiscal measures, estimated to yield additional revenue of Tk. 196.76 crore, will partially close the gap in the financing for the current Annual Development Programme of Tk. 3825,72 crore. Foreign aid and grant, therefore, will be the main sources of financing the development budget. According to the Adviser for Finance, who announced the budget on 30 June 1985 at the old Assembly House, the budget, while providing adequate incentive for entrepreneurs, will also assure socio-economic justice. Besides, it is expected to provide a viable and rational revenue base, with emphasis on direct tax, for mobilizing additional resources for raising Government expenditure. He referred to the formulation of the Third Five-Year Plan which will have poverty alleviation as its central theme by focusing on employment and income generation.

According to the document accompanying the budget, GPD has recorded a growth of only 3.8% which 2.4% below the target of 6.2%. Last year the GDP growth rate was 4.2%. The economic review of 1984-85 indicated that the growth rate of the agricultural sector was only 3.8%, while having a target of 5%. The industrial sector recorded a growth rate of 4.3% as compared to a target rate of 8.4%, and the tax-GDP ratio was 8.3% as compared to a target of 9.5%. Food production during the year was 158 lakh tons against the target of 175 lakh tons. The export target increased by less than 7% against the target of 8.6%. The per capita income dropped by 1.7% compared to 2% in the preceding year. The foreign exchange reserve at the end of the financial year was at Tk. 944 crore (388 million dollars), as against Tk. 1290.19 crore (518 million dollars) during 1983-84. This (1984-85) was the last year of the Second Five-Year Plan (1980-85). The Economic Review pointed out the deterioration in the field of foreign trade and aid; natural calamities, draugth and flood affected the economy adversely during the period.

The Finance Adviser, in his Budget speech, detailed a number of measures aimed at boosting production and improving the economy. He laid emphasis on keeping the size of the Government and non-development expenditure under control. He also underscored the increasing role of the private sector in the fields of industry and trade for proper economic growth, particularly in view of the launching of the Third Five-Year Plan (1985-1990). He indicated that by providing broad-based capital investment, companies will be allowed to play their role. The Adviser of Finance also discussed the need for selective investment.

THE NEW FISCAL MEASURES: THE FINANCE ORDINANCE 1985

The new taxes and other fiscal measures, under the National budget for 1985-86, are expected to mobilize Tk. 196.56 crore. Under the new budget the Government will mobilize Tk. 55 crore from Income Tax; Tk. 82 crore from Excise Duties; Tk. 23 crore from Customs Duties; and, Tk. 6 crore from Sales Tax. Besides, there are heads of non-tax revenue. Under the new fiscal measures the land development tax has been enhanced by 50% and 100%, depending upon the use and location, i.e., commercial, industrial, residential or other purpose. The new rates are shown as per annex "A".

The fiscal measures and policy changes are reflected in the Finance Ordinance 1985, in the form of a legal provision for enforcement and collection of tax. In particular, various amendments have been made in the I.T. Ordinance 1984 which has been in force from 1 July 1984. Some of the significant changes are noted below.

INCOME TAX

(a) In view of the increase in the cost of living, the personal exemption limit of income has been raised from Tk. 20,000 to Tk. 30,000.

(b) Tax rates have been restructured and the tax has been reduced at every slab. In the new rate schedule, the highest rate has been lowered from 60% to 50% for assessees other than companies and registered firms. The existing nine slabs have been reduced to five, and at the same time, the procedure for tax calculation has been simplified.

(c) In respect of registered firms, the highest tax rate of 30% has been lowered to 25%, slabs in the rate schedule have been reduced from 6 to 5 and the procedure of tax calculation also has been simplified.

(d) To encourage higher production, and consequently generate additional employment opportunities, a system of tax rebate has been provided for companies. If the volume of production increases by more than 15% over the preceding year, a rebate of 2½% in tax will be allowed. This rebate will be 5% if the volume of production increases by more than 25% over the preceding year.

(e) Provision has been made for rebate of 25% of tax attributable to income from passenger buses and launches. The new measure is expected to induce more investment in these sectors, and help improve facilities provided to the passengers.

(f) The upper limit of income which can be declared under the self-assessment scheme has been raised from Tk. 100,000 to Tk. 125,000. The existing limit for induction of capital up to Tk. 1 lakh by new assessees engaged in business or profession without any questions being asked, has been raised to Tk. 5 lakh for the assessment year 1985-86.

(g) At present, assessees with income exceeding Tk. 50,000 are required to compulsorily submit a statement of assets, liabilities and expenses. This limit has been enhanced to Tk. 80,000, in view of the raising of the exemption limit of income from Tk. 20,000 to Tk. 30,000.

(h) New industrial undertakings formed prior to 30 June 1985 are presently entitled to a tax holiday. This facility has been extended for another five years until 30 June 1990. The period of the tax holiday has been fixed at 9 years for the least developed areas, 6 years for less developed and 4 years for developed areas. The tax holiday period for special economic zones, shall, however, continue to be 12 years. the rates of reinvestment of profit under this scheme have been fixed at 30% for developed, 15% for less developed and 5% for least developed areas and special economic zones.

(i) The existing tax concessions for newly constructed residential houses have been extended up to 30 June 1990.

(j) Capital gains arising from the transfer of land or building towards equity of a new industrial company, has been exempted from tax. Similarly, capital gains arising from the transfer of land or building which is invested in the purchase of new shares quoted on the stock exchange, has been exempted from tax. Further, to encourage formation of new companies, capital gains arising out of the process of transformation of a firm into a company, has also been exempted from tax.

(k) To encourage investment in shares and stimulate saving through banks, the exemption limit of dividends and interest from bank deposits have been raised from Tk. 5,000 to Tk. 15,000. A similar benefit has been extended to the Islamic banks.

(l) To encourage literary work of a creative nature, income from such literary work has been totally exempted.

(m) Due to the increase in the price, the value limit for the purpose of a depreciation allowance on motor vehicles not plying for hire, has been raised from Tk. 150,000 to Tk. 200,000.

(n) To widen the scope of publicly traded companies, it has been decided to make available the concessionary rate of tax, i.e., income tax at 45% to the existing companies, subject to conversion into publicly traded companies on fulfilment of prescribed conditions.

(o) A system of deduction of advance taxes at 2% on the import value of certain selected items has been introduced. This measure is expected to curb evasion of tax by certain importers.

(p) A terminal date for determining the liability for payment of advance tax has been specified through an amendment of the Income Tax Ordinance. Public Limited Company/Public Company and Industrial Company have been defined.

GIFT TAX

The Gift Tax Act 1963 has been repealed as of 1 July 1985. Notwithstanding the repeal, the pending assessment will be governed by the Act and the rules made thereunder.

WEALTH TAX

At present, for wealth tax purposes, net taxable wealth is arrived at by deducting, among others, the value of agricultural land up to Tk. 1 lakh from gross wealth. This deductible limit was introduced in 1969. Taking the present price level into consideration, it has been decided to raise the limit to Tk. 3 lakh.

RATE OF STAMP DUTY

At present, there are 5 slabs of stamp duty; 6%, 9%, 12%, 15% and 17%. In order to bring uniformity, the highest slab of 17% has been raised to 18%.

EXEMPTION OF STAMP DUTY

Payment of stamp duty has been exempted on transfer of land owned by an entrepreneur by way of equity participation, only to a limited company incorporated for setting up industry.

Existing price of copy stamp in use in the country is forty paisa. This rate had been in force for the last nine years. The price of copy stamps has been raised to Tk. 2.00 to keep pace with the present situation.

ANNEX A

Existing and new rates of land development tax on non-agricultural land

Location of land	Discription of land according to use	Rate of existing tax per decimal (in Taka)	Rate of new tax per decimal (in Taka)
1	2	3	4
29 specified Thana/Upazila of Dhaka, Chittagong and Khulna	a) Land used for industrial and commercial purposes	60.00	100.00
	b) Land used for residential and other purposes	12.00	20.00
Municipal areas of old District Headquarters.	a) Land used for industrial and commercial purposes.	10.00	20.00
	b) Land used for residential and other purposes.	4.00	6.00
Other areas	a) Land used for industrial and commercial purposes	8.00	15.00
	b) Land used for residential and other purposes	3.00	5.00
Tea gardens	Agricultural land	0.75	1.10

ANNEX B

THE SECOND SCHEDULE
(See section 9)

Rate of income tax

A. In the case of every individual, Hindu undivided family, unregistered firm, association of persons and every artificial juridical person referred to in section 2(46) of the Income Tax Ordinance 1984 (XXXVI of 1984, not being a case to which paragraph B applies) –

	Rates
(1) On the first Tk. 50,000 of taxable income	10%
(2) On the next Tk. 50,000 of taxable income	20%
(3) On the next Tk. 50,000 of taxable income	30%
(4) On the next Tk. 0,000 of taxable income	40%
(5) On the balance of taxable income	50%

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 18 and 20 of Part B of the Sixth Schedule to the Income Tax Ordinance 1984 (XXXVI of 1984), does not exceed Tk. 30,000; and

(ii) the income tax payable shall in no case exceed –
  - (a) one-third of the amount by which the total income exceeds Tk. 30,000; or
  - (b) the amount representing 50% of the total income, whichever amount is the less.

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 section 2(63) of the Income Tax Ordinance 1984 (XXXVI of 1984).

B. In the case of every company and local authority and in every case in which, under the provisions of the Income Tax Ordinance 1984 (XXXVI of 1984), income tax is to be charged at the maximum rate:

	Rates
(i) On the whole of the total income excluding the amount representing income tax from dividends from a company having its registered office in Bangladesh –	
(a) in the case of every industrial company being a publicly traded company	45 % of such income
(b) in the case of every industrial company not being a publicly traded company	50% of such income
(c) in the case of all other companies including banks, financial institutions and local authorities	60% of such income
(d) in the case of a person not being a company who is not resident in Bangladesh.	30% of such income

Provided that a rebate at the rate of 10% of the tax shall be allowed to a company registered in Bangladesh under the Companies Act 1913 (VII of 1913), on such much of its income, profits and gains accruing or arising outside Bangladesh, to which section 9(4) of this Ordinance does not apply, as are brought by it into Bangladesh.

Provided further, that a company registered in Bangladesh under the Companies Act 1913 (VII of 1913), and engaged in the production of goods, shall be allowed a rebate on income tax payable by it at the following rates in the manner specified hereunder:

	Amount
(a) Where the production in volume of the relevant year exceeds 15%, but does not exceed 25% of the production in volume of the preceding year;	2.5% of the income tax attributable to such income.
(b) Where the production in volume of the relevant year exceeds 25% of the production in volume of the preceding year;	5% of the income tax attributable to such income.

	Amount
(ii) On the amount representing income from dividends declared and paid by a company 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 1: The expression "industrial company" means a company which is mainly engaged:

(i) in the manufacture or processing of goods;

(ii) in the manufacture of plants, machinery, tools and implements, or accessories of all descriptions;

(iii) in the construction of vessels, or in the manufacture of vehicles; or

(iv) in the exploration and extraction of gas, oil, or any other minerals.

Provided that the income, profits and gains of the industrial company attributable to one or more of the undertakings mentioned above and included in its total income of the income year is not less than 2/3 of such total income.

Explanation 2: 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;
(b) the paid-up capital of the company is not less than Tk. 20 lakh;
(c) at least 50% of the paid-in capital of the company as at the end of the accounting years 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 owner-ship of shares of the company is at least 1 for each Tk. 20,000 of the paid-in capital;
(f) at least 10% dividend has been delcared and distributed to the shareholders of the company out of the profits of the accounting year for which assessment is to be made; and
(g) the shares of the company are listed on a stock exchange before the end of the accounting year for which assessment is to be made.

C. In the case of every registered firm, the income tax shall be charged at the following rates:

	Rate
(1) On the first Tk. 30,000 of total income	Nil
(2) On the next Tk. 30,000 of total income	10%
(3) On the next Tk. 70,000 of total income	15%
(4) On the next Tk. 70,000 of total income	20%
(5) On the balance of total income	25%

Provided that income tax shall not payable by a registered firm in respect of the income, profits and gains derived by it from the exercise of a profession if such income, profits and gains depend wholly or mainly on the personal qualifications of its partners who are prevented by any law, for the time being in force, or by convention or rules or regulations of the professional association, society or similar body of which they are members to constitute themselves into a corporate body with a limited liability which can be registered as a company under the Companies Act 1913 (VII of 1913), unless such profession consists wholly or mainly in the making of contracts on behalf of other persons, or the giving to other persons of advice of a commercial nature in connection with the making of contracts.

Explanation: The term "registered firm", as used in this paragraph, means a firm registered under section 111 of the Income Tax Ordinance 1984 (XXXVI of 1984).

U.S.A.:

FIRPTA AND TAX TREATIES

Revenue Ruling: United States-Canada Income Tax Convention FIRPTA regulations applied to Tax Convention*

A recent revenue ruling, reproduced below, rekindles the debate concerning the position of FIRPTA regulations in relation to U.S. treaty obligations and the larger question of the legality of overriding treaty obligations by later conflicting domestic legislation.[1]

The Foreign Investment in Real Property Tax Act of 1980[2] (commonly referred to as FIRPTA) was enacted in order to tax the capital gains of "foreign" taxpayers, i.e. non-resident alien individuals and foreign corporations, who previously were only taxed on capital gains "effectively connected" with a U.S. trade or business.[3] Before FIRPTA was enacted, it was possible for the foreign taxpayer, through various tax planning methods,[4] to avoid U.S. capital gains tax on the sale of his U.S. real property, even though such property had been used in a U.S. trade or business. FIRPTA provides that gain or loss of a non-resident alien individual or foreign corporation from the disposition of a U.S. Real Property Interest (hereinafter "USRPI") will be taken into account *as if* the taxpayer were engaged in a trade or business within the U.S.[5] Since its enactment, FIRPTA has been amended in several minor respects and, more significantly, in 1984 by implementation of withholding at source[6] which supplants some of the onerous information reporting requirements originally imposed by FIRPTA legislation.[7] FIRPTA expressly included a clause overriding conflicting treaty obligations (see discussion below), but provided a 5-year transition period during which it was expected that conflicting treaties could be renegotiated taking FIRPTA provisions into account.[8]

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* This case note was written by Patricia Dunn, J.D., former managing editor of the Bulletin for International Fiscal Documentation.

[1] See, for example, "Override of Tax Treaties by Ordinary Legislation" in 34 *Bulletin for International Fiscal Documentation* (1980) at 552.

[2] The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), P.L. 96-499 added to the Internal Revenue Code (IRC) as section 897.

[3] 3 *Taxes International* (November 1979), at 1.

[4] U.S. Treas. Rep., *Taxation of Foreign Investment in U.S. Real Estate* (May 1979).

[5] IRC section 897(a), emphasis added.

[6] IRC section 1445, enacted by the Deficit Reduction Act of 1984 (the 1984 Act).

[7] IRC section 6039C. Because the information reporting requirements would have compelled disclosure of the identities of foreign persons whose U.S. real property investment was at most indirect and whose liability to U.S. tax was remote, section 6039C was never implemented. The 1984 Act limited the scope of section 6039C and enacted the withholding requirements of section 1445. Reported in 63 *Journal of Taxation* (August 1985), footnote 2, at 99.

[8] FIRPTA section 1125(c). Negotiations for the new U.S.-Canada Convention took FIRPTA into consideration. See statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy) on the Canadian income tax treaty before the Senate Foreign Relations Committee on 24 September 1981 (R-368); Explanation of proposed income tax treaty (and proposed protocols) between the U.S. and Canada prepared by the staff of

To avoid running afoul of the anti-discrimination clause generally found in tax treaties between the U.S. and its treaty partners,[9] FIRPTA provides that a foreign corporation may elect to be treated as a domestic corporation for FIRPTA tax purposes.[10] It would appear, therefore, that the U.S. has gone to some effort to conform FIRPTA to its tax treaty obligations and, where that was not possible, to provide a lengthy transition period. As the instant revenue ruling makes clear, however, potential problem areas are still in evidence.

Revenue Ruling 85-76[11]

In re:
Canada; U.S. real property transactions.

ISSUE

If, under the circumstances described below, a Canadian resident derives gain in 1985 from the sale of undeveloped land situated in the United States, do the terms of the treaty agreements between the United States and Canada exempt that gain from United States income tax?

FACTS

On January 2, 1985, A, a resident of Canada, purchased undeveloped land in the United States as an investment for 2x dollars. A sold the undeveloped land for 3x dollars on June 15, 1985. A has no permanent establishment in the United States, and A's books and records are maintained on a calendar year basis.

LAW AND ANALYSIS

Section 897 of the Code was enacted by section 1122 of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), which is subtitle C of title XI of the Omnibus Reconciliation Act of 1960, 1960-2 C.B. 509. Section 897(a)(1) provides, in part, that gain or loss of a non-resident alien individual or a foreign corporation from the disposition of a United States real property interest is taken into account for purposes of sections 871(b)(1) and 882(a)(1) as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.

In situations where a prior treaty obligation of the United States exempted from taxation the gains that are described in section 897, section 1125(c) of FIRPTA supersedes the obligation and provides effective dates for the taxation of those gains.

Article VIII of the former United States-Canada Income Tax Convention, 1943 C.B. 526, as amended (the 1942 Convention), contains a provision exempting from United States income tax all gains derived in the United States from the sale or exchange of capital assets by a resident of Canada, provided that the Canadian resident has no permanent establishment in the United States.

The new United States-Canada Income Tax Convention (the New Convention) was ratified and entered into force subsequent to the enactment of FIRPTA. Article XIII of the New Convention allows the United States to tax gains derived by a resident of Canada from the alienation of real property situated in the United States.

Paragraph 2(b) of Article XXX of the New Convention provides that, for taxes other than taxes withheld at the source on dividends, interest, royalties, and pensions and annuities, the provisions of the New Convention shall have effect for tax years beginning on or after the first day of January next following the date on which the New Convention enters into force. The New Convention entered into force on August 16, 1984. Thus, for a taxpayer that files income tax returns on a calendar year basis, the effective date for taxes covered by paragraph 2(b) of Article XXX is January 1, 1985. Among the taxes covered by paragraph 2(b) of Article XXX is the tax permitted by Article XIII of the New Convention, described above, which concerns United States taxation of gains by Canadian residents from sales of United States realty. Thus, taxation of gains such as A's is permitted by Article XIII for tax years beginning on or after January 1, 1985.

Paragraph 5 of Article XXX of the New Convention, however, states that where any greater relief from tax would have been afforded by any provision of the 1942 Convention than under the New Convention, any such provision shall continue to have effect for the first taxable year with respect to which the provisions of the New Convention have effect under paragraph 2(b). Under A's circumstances, Article VIII of the 1942 Convention affords greater relief than does Article XIII of the New Convention.

Since the New Convention was ratified and entered into force subsequent to the enactment of FIRPTA, the effective date provisions of the New Convention apply to the present situation, and section 1125 of FIRPTA does not apply. See *Cook v. United States*, 288 U.S. 102, 118-119 (1933); *United States v. Lee Yen Tai*, 185 U.S. 213, 220-221 (1902). The Senate Foreign Relations Committee, in its report on the New Convention, expressly adopted the view that paragraph 5 of Article XXX extended by one year the date on which Canadian residents would first be subject to United States taxation of gains derived from alienation of real property situated in the United States. See S. Exec. Rep. No. 22, 98th Cong., 2d Sess. 10 (1984).

Accordingly, Article VIII of the 1942 Convention continues to be effective for tax years beginning before January 1, 1986, where, as in the present situation, the taxpayer concerned would receive greater United States tax relief under that provision than under Article XIII of the New Convention. In such situations, the tax permitted by Article XIII of the New Convention applies only to real property gains derived in tax years beginning on or after January 1, 1986.

HOLDING

Pursuant to paragraph 5 of Article XXX of the New Convention, Article VIII of the 1942 Convention continues to be effective for A's tax years beginning before January 1, 1986. Thus, A's gain in 1985 is exempt from United States tax.

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the Joint Committee on Taxation JCS-20-84-25 April 1984; etc., as reported in P-H Federal Taxes, Tax Treaties I, Canada.

[9] See as an example, U.S. Treasury Department's Model Income Tax Treaty of 16 June 1981, Art. 24.

[10] IRC section 897(i).

[11] Internal Revenue Bulletin 1985-23 of 10 June 1985, reported in 11 P-H Federal Taxes 1985, para. 54, 960 and in Tax Notes of 17 June 1985. Published revenue rulings do not have the force and effect of Treasury Department regulations, but they may be used as precedents. 11 P-H Federal Taxes (1985), para. 54, 502.

COMMENT

Holding relies on treaty provisions

The issue is formulated in this ruling in such a manner as to compel reliance on the tax convention for resolution.

The ruling assumes that there is a conflict between the exemption permitted in the 1942 Convention and FIRPTA. The FIRPTA override clause, section 1125(c), is given rather short shrift; it simply states that section 1125(c) supersedes conflicting short prior treaty obligations.

Section 1125(c) provides that:

> Except in cases where a treaty is renegotiated prior to 1985, a treaty that exempts foreign capital gains on real property from taxation will be inapplicable in the case of transactions conducted after 1984. If an existing treaty is renegotiated prior to 1985, the new treaty may designate the effective date of Code Sec. 897, but the designated effective date cannot be more than two years after the signing of the renegotiated treaty.[12]

Although the new convention[13] does not designate an effective date for implementation of Code Sec. 897 as such, it does, given the date of entry into force and the provisions of para. 5 of Article XXX, fall within FIRPTA section 1125(c). A rather strained reading of section 1125(c) could have reconciled FIRPTA with the new convention. But, as the new convention was ratified and entered into force subsequent to the enactment of FIRPTA, the instant ruling held that the treaty controlled, citing two U.S. Supreme Court cases.[14]

U.S. attitude toward overriding

The U.S. position is that, through the Supremacy Clause of the U.S. Constitution,[15] treaties hold equal footing with laws as the supreme law of the land. Wherever possible, treaties and laws dealing with the same subject are to be read in a consistent manner[16] (as might conceivably have been done in this ruling). However, where there is a conflict, the last in date controls,[17] where domestic legislation is last in date and conflicts with treaty obligations, an expressly worded override clause such as FIRPTA section 1125(c) gives added weight to the "last in date" rule.

As can be readily noted in the instant ruling, the Internal Revenue Service followed this approach precisely; FIRPTA supersedes the 1942 Convention, but the new convention is subsequent to FIRPTA and thus it controls.

By supplying no reasoning for the statement that FIRPTA supersedes prior conflicting treaty obligations, and basing the instant decision on the new convention, this revenue ruling does little to resolve the conflict between domestic legislation and prior treaty obligations.[18] This is especially so as the 1942 U.S.-Canada Convention was, at the time of implementation of FIRPTA, the only U.S. treaty not providing for the taxation of capital gains derived from direct disposition of a U.S. real property interest.[19] The question as regards direct taxation in this area is, therefore, no longer relevant.

Indirect transfers cause confusion

However, the problem is very much alive, not as it concerns foreign capital gains derived from a direct disposition of a U.S. real property interest but as it concerns capital gains derived from distributions of shares in a corporation or in a Real Property Holding Corporation (RPHC). Several U.S. treaties[20] provide for exemption of such gains in the U.S. FIRPTA specifically includes RPHCs in the tax net.[21]

Generally, the gain on transfer of shares is subject to tax in the country of residence of the shareholder. Treaty problems arise, for example, in the following situations:

> A, a resident of a U.S. treaty partner, owns shares in X corporation, a RPHC having many shareholders and significant investments in U.S. real property. A, as an ordinary shareholder and in no way changing the substance or structure of X corporation, sells his shares to B, also a resident of said U.S. treaty partner. Under the tax treaty, gains derived from this sale are considered, by the State of residence of A and B, as gains derived from the sale of shares in a corporation and, as such, are taxable in said State of residence. Under the FIRPTA regulations, the gain derived from the transfer of shares is considered to be derived from the transfer of an interest in real property (even though title to said real property remains in the hands of X corporation) and is, as such, taxable in the U.S., in spite of treaty obligations to the contrary.

Admittedly, although the U.S. is attempting, as it renegotiates its treaties, to rectify what can be a confus-

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12. I CCH Federal Tax Guide (1985), para. 5199A.

13. Convention between the United States of America and Canada with Respect to Taxes on Income and Capital, entered into force on 16 August 1984. For full text see P-H Federal Taxes, Tax Treaties I.

14. See instant revenue ruling.

15. U.S. Const. Art. VI, Clause 2.

16. Head Money Cases, 112 U.S. 580 (1884), reported in Langer, op. cit., 34 *Bulletin for International Fiscal Documentation* (1980), at 552.

17. Ibid., at 552.

18. Additionally, even though a revenue ruling may be cited as precedent (see footnote 1), reliance on the treaty here may have relegated any FIRPTA discussion to mere dicta.

19. The former U.K.-U.S. Income Tax Convention had a similar exemption clause (Art. XIV) to the 1942 Canada Convention. A new U.K.-U.S. treaty eliminating that clause was ratified in April 1980 (the same year FIRPTA was implemented) and had retroactive effect.

20. See, for example, U.S.-France income tax treaty, Art. XII; U.S.-Netherlands income tax treaty, Art. XI; U.S.-Sweden income tax treaty, Art. IX. Prentice-Hall's commentary to the capital gains clause in the U.S.-Sweden income tax treaty refers to a seeming inconsistency between Art. V, which permits the taxing of income from real property (including gain from sales) by the country in which the property is located, and Art. IX, which exempts from the tax of one country the gain from the sale of capital assets by a resident of the other country. The matter was clarified by Regulation and confirmed by case law excluding the gains from the sale of real property from the provisions of Art. IX. See P-H Federal Taxes, Tax Treaties II, Sweden, section 81,010.

21. IRC section 897(c).

ing situation (as it often is difficult to become aware of profits in a case similar to our example or to determine what portion of profits is attributable to gains from the sale of a USRPI, and what portion is either exempt from tax or taxable under some other provisions) the negotiation of an income tax treaty is a time consuming process[22] and, for those treaty partners who have not as yet reached agreement with the U.S. on this issue, it may be a source of resentment fueled by an opinion that the U.S. does not adhere to its treaty obligations.[23]

Previous private letter ruling overruled

The holding in the instant revenue ruling is in opposition to that taken in a previous private letter ruling (PLR) having a very similar fact situation.[24] In the previous PLR, a U.S. subsidiary wished to completely liquidate to its Canadian parent corporation. The domestic subsidiary had been engaged in investment in commercial U.S. real property and sold all its U.S. real property in September 1984. At the time of the PLR, the subsidiary's assets included an installment obligation with respect to the sale of U.S. real property which constituted a USRPI[25] under FIRPTA.[26]

Unlike the instant revenue ruling, the previous PLR did not take into account the express intent of the Senate Foreign Relations Committee that Art. XXX of the new convention should extend the exemption provided in the 1942 Convention by one year. Rather, the PLR was based on a technical reading of FIRPTA and it seems likely that the treaty override issue was not considered in determining the outcome of that PLR.[27]

It should be noted that, unlike a revenue ruling, a PLR may not be cited or used as precedent.[28] Therefore, the previous PLR, now overruled, had no legal value. However, as might be expected, PLRs are read with interest in the tax community in order to appraise the general attitude and outlook of the IRS regarding current issues.

Conclusion

What is needed is a revenue ruling relating specifically to the question of indirect transfers, through shares in a corporation, of gains derived through an interest in real property located in the U.S. where, were it not for FIRPTA, the application of treaty provisions would be determinant of the outcome.

However, as legislation has been introduced to repeal FIRPTA,[29] the question of indirect transfers, like that of direct transfers, may too soon become irrelevant.

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[22] Brockway, op. cit., 34 *Bulletin for International Fiscal Documentation* (1980), at 554.

[23] The concept of later domestic legislation superseding a duly ratified treaty is generally alien in civil law countries. See, for example, the Constitution of the Netherlands, Art. 94.

[24] PLR 8513038 of 31 December 1984 reported in *Tax Notes* (8 April 1985), at 159. Unlike a revenue ruling, a private letter ruling may not be used or cited as precedent; IRC section 6110(j)(3).

[25] What constitutes a USRPI for FIRPTA purposes is defined in IRC section 897(c).

[26] The IRS concluded that the 1942 U.S.-Canada income tax treaty would only cover the USRPI-related gain prior to 1985. After liquidation, the parent's pre-1985 USRPI-related gain would be exempt, but its post-1984 gain would not be. It should be noted that one of the conditions imposed by the IRS for approval of the merger was the agreement to pay FIRPTA tax.

[27] 14 Tax Management International Journal 6, at 209.

[28] See footnote 24, above.

[29] FIRPTA Repeal Bill, S. 758, sponsored by Senators Wallop and Bentson, reported in TNS (1985) 84, and in U.S. Business Briefing (15 April 1985), at 4. One of the reasons for seeking repeal, according to Senator Bentson, is that FIRPTA conflicts with many U.S. tax treaties.

AUSTRALIA:

Reform of the Taxation System

Statement made by the Treasurer, the Hon. Paul Keating, M.P., on 19 September 1985.

Mr. Speaker,
Since its election in 1983, the Hawke Government has consistently pursued policies directed towards restoring strong economic growth and creating a fairer Australian society.
By any measure our strategy has been an outstanding success.
For the past two financial years this nation has recorded growth rates that are the envy of the Western world.
Under this Government over 430,000 more Australians have found jobs, inflation has been cut significantly from the double digit legacy of our predecessors and we have arrested and turned around the blow-out that we inherited in the Commonwealth budget deficit.
We now confidently anticipate a third year of strong growth.
And despite the protestations of the doomsayers, after I brought down the Budget last month, that prospect is being confirmed repeatedly by a series of positive economic indicators.

Mr. Speaker, the achievement of sustained high growth rates remains the over-riding economic objective of this Government.
We have policies set for growth.
Not because that is an end in itself.
But because it is only through economic growth that we can cut unemployment.
It is only through growth that we can increase assistance to the needy.
And it is only through growth that we can generate the higher living standards that the whole community desires.
If we are to maintain the momentum of growth it is essential that we act now.
We must be prepared to tackle head-on the issues that in the past have been consigned to the too hard basket.
We must be prepared to debunk the myths and overturn the barriers that stand in the way of our goal.
This Government is prepared to do that.
Today we are taking the hard decisions, confronting the issues and embarking upon a very substantial reform to the Australian national economy.

Mr. Speaker,
For the first time in Australia's recent history a Government has been willing to place tax reform on the political agenda.
But much more than that, for the first time a Government has been willing to act.
We have invited debate, we have asked the people of Australia to express their views and we have listened carefully to what they have said.
The tax reform measures I am announcing today are the outcome of that unprecedented process of consultation.
While they do not include a broad based consumption tax of the kind proposed by the Government at the July Tax Summit, they do represent the most far reaching reform of the Australian tax system to be undertaken by a Government in living memory.
Today we are addressing a crisis in our national taxation system that has been left by a succession of Governments to compound year upon year.
There was a time when Australia had a reasonably sane and credible taxation system.
But that time is long gone.
The system has been broken and beaten by an avalanche of avoidance, evasion and minimisation.
And more so than in any other period in Australia's history, the taxation system deteriorated during the stewardship of the previous Government.
During those seven years tax avoidance became the norm for hundreds of thousands of Australians.
Taxpayers were allowed the indulgence of moving into contrived artificial paper avoidance and evasion schemes – including those of the criminal variety.
The Government of the day was tardy in acting to stem the blatant abuses that were occurring before its very eyes.
More than that, it failed to act at all to tackle the underlying problems.
It is the deterioration and decay that occurred during the late 1970s and early 1980s that has now made substantial reform so essential.
For years Australians have gained satisfaction from believing that their tax system was progressive.
That those who could afford to shoulder a greater share of the burden did so.
Today, that is a fiction.
The system no longer works that way.
The top marginal tax rate – the 60 cents in the dollar rate – has been paid by barely a few of those whose income should place them in that bracket.
Tens of thousands of these people have walked away from the system.
In their place middle income Australians have been forced to take up the load.
These are the people who have not been in the position to arrange their affairs to take advantage of the tax shelters, the schemes and the concessions.
They have not joined in what had, for higher income earners, become the socially acceptable business of avoidance and evasion.
But it is they who have sustained the system during the past decade.
What we have seen is a dramatic compression in the application of the marginal tax rates, so that, where at the beginning of the 1970s the top rate came in at the current equivalent of $110,000, today it comes in at $35,000.
In the early 1970s the top rate applied at five times average weekly earnings.
Today it applies at 1½ times.

Mr. Speaker, it is for these reasons that from the outset a major objective of tax reform has been to substantially lighten the heavy hand of high marginal tax rates on honest taxpayers in this country.
It would be stupid not to recognise the lesson of recent history; taxpayers just will not pay ridiculously high marginal tax rates.
The system invites abuse if it attempts to impose such a burden.
The time has come when the facts must be faced.
Change is needed.
And if this nation is to continue to progress, it is needed now.
Lower marginal rates will enhance our economic performance by better rewarding initiative.
They will help generate growth by increasing rewards for work relative to those from tax avoidance and evasion.
And they will make for a better nation by reducing distortions in the savings and investment decisions of ordinary Australians.

Mr. Speaker,
A fundamental and major reform which this Government will undertake is to reduce the top rate of income tax from 60 cents in the dollar to 49 cents in the dollar.
Further, we will cut the intermediate rate of personal income tax from 46 cents in the dollar to 40 cents.
This slashing of marginal tax rates represents a dramatic and permanent reform to the Australian tax system.
It will mean that in the future no Australian will be required to pay more than half his or her income in taxation.
It is this action along with the abolition of shelters and the introduction of stronger penalties which will act to end the rorts and abuse of the system.
Combined with our expensive reform a year ago to drop the bottom personal income tax rate from 30 to 25 cents in the dollar, today's measures will restore the system's effective progression.
They also make possible the vital innovation of aligning the top personal income tax rate with the company tax rate.
In a stroke this will make a whole host of tax avoidance devices futile.
Further, in this package for the first time a Government in this country will have recognised the call from shareholders of Australian companies to remove the double taxation of dividends.
This is a reform which was denied in 30 years of Coalition Government.
From today the Government will also have ended the debate which has persisted in Australia for decades as to whether income taken as capital ought to be exempt from tax.
We will establish a capital gains tax so that in the future taxpayers who take their income in the normal manner will not be dis-

advantaged as against taxpayers who choose to take their income as capital.

Mr. Speaker, the benefits of tax reform will be shared among all Australians.
A number of measures are to be taken to relieve poverty traps in our social security system.
These changes will involve easing the income tests applied to pensioners and beneficiaries and will increase the incentive available to these people to earn extra income.
This whole group of reforms – reductions in marginal rates, the alignment of the top personal rate with the company tax rate, the full imputation system for relief of dividend tax, the capital gains tax and the action to relieve poverty traps – makes this statement of reform the most comprehensive in the modern era.

Mr. Speaker,
This reform package launches an attack on tax shelters and sectional practices.
Measures that even-up the taxation treatment of different industries will attract resources to where they earn the greatest real profits, rather than to where they attract the greatest concessions or generate the largest tax deductible losses.
It is true that tax shelters and other minimisation devices may, on occasions, stimulate particular industries or activities.
But it must be understood that whenever such a subsidy is conceded it involves a real – and largely hidden – cost to the rest of the community.
Ultimately, every tax concession, minimisation scheme or evasion rort means that all of those who do not benefit must shoulder a greater burden.
More often than not it is the higher income earners who benefit from exploitation of these practices.
Again, it is the middle income earners – ordinary tax paying Australians – who must shoulder the difference.
By broadening the income tax base and closing loopholes, today's measures will achieve a return to fairness in the Australian tax system not seen for decades.
Australian society will be much the stronger for it.
These measures, and this reform package, are not about raising revenue for the Government.
The total yield of this package will be returned to taxpayers.
Not only that, it incorporates tax cuts to be delivered in satisfaction of the Government's commitment to continued wage restraint.
In all, significant cuts will be delivered to everyone in the community save those taxpayers who have made a feast of tax avoidance and evasion.
Next financial year tax cuts totalling $2 billion will be delivered to all taxpayers.
Of this $2 billion, $800 million will be netted in that year from the tax reform measures.
In the following financial year the cost of the tax cuts will be about $4½ billion, of which the growing yield from the tax reform measures will account for about $1½ billion.
In other words, the cost to revenue of the cuts will far outweigh the proceeds from the new tax measures.
Putting these figures in individual terms will mean that in the first year the average income earner will receive an income tax cut of $9 per week.
In the second year, a further reduction in the tax scales in July 1987 will bring the total tax cut for the average income earner to $15.20 a week.
None of these tax cuts will be financed by adding to the Government's deficit.
They will be achieved by the most rigorous restraint on public sector outlays.
This Government has already demonstrated its economic credentials.
We are committed to responsible and prudent fiscal policy.
We have more than halved the deficit as a proportion of Gross Domestic Product in three years.
We have curtailed outlays growth to its lowest rate in six years.
The Government entered the discussions with the trade union movement on wage restraint with a total commitment that the budgetary scope to finance these cuts would be found through expenditure restraint.
The tax package is part of our overall strategy designed to promote growth.
This Government knows that responsible and appropriate fiscal policies are an essential element of macro-economic management.
We will not put sustained economic growth at risk by relaxing fiscal discipline.
Details of the proposed measures are provided in attachments to my printed speech, which I shall table on conclusion.
I shall now outline the main features of the Government's reforms.

FRINGE BENEFITS

There has been an accelerating shift in recent years toward the payment by employers of remuneration in the form of fringe benefits.
While not readily admitted as such, this shift often has all the hallmarks of outright tax evasion.
High marginal income tax rates have played a major part in providing the incentive for this trend – and we will rectify that problem in this package.
However, the growing shift to fringe benefits has been a major factor in reducing the tax liabilities of predominantly higher income taxpayers.
An increasing awareness of these "perks" has highlighted the unfairness of the tax system and has contributed to undermining taxpayer morale.
As a consequence, the Government will be proceeding with the taxation of fringe benefits broadly along the lines described in the draft White Paper on Reform of the Australian Taxation System.
That will mean taxing all of the major fringe benefits, whether received in cash or otherwise.

Non-cash fringe benefits

In the case of non-cash fringe benefits, the tax will be payable on the assessed value of the benefits provided to employees and will be levied on the employer at the prevailing company tax rate.
Initially that will be 46 cents in the dollar, changing later in line with the alterations to the company tax regime.
The type of benefits to be taxed include employer-provided motor vehicles, free or low interest loans, residential accommodation, goods and services sold at below cost or provided free by an employer and expenses paid on behalf of an employee.
The valuation rules to apply in each case are detailed in the attachments.
In the case of motor vehicles where no records of costs or business use are maintained, a proportion of the purchase price of the car will be subject to the tax at the relevant company tax rate.
Under these rules, the maximum tax payable on each car will be around 11% of the purchase cost. Lower levels of tax apply where the total distance travelled by the vehicle during the year exceeds specified threshold levels.
If a higher proportion of business use can be substantiated there will be the option of maintaining cost records and log books detailing the breakdown between private and company use.
The fringe benefits tax will not apply to benefits associated with employer contributions to superannuation funds and employee share acquisition schemes, which are already subject to specific taxation provisions.
The tax will be designed to have little or no effect on the many small, traditional employer-provided benefits such as most staff discounts.
A complete exemption applies to staff canteens, free commuter transport fares, the home to work use of taxis and commercial vehicles and child care facilities on employers' premises.
Special concessions will apply to housing and travel benefits provided to employees in specified remote areas.
All employers, with the exception of religious bodies, will be liable for the tax, including the Commonwealth, State and local governments.
Clearly, government bodies other than the Commonwealth will incur a direct liability if they choose to provide such fringe benefits.
In the case of the Commonwealth any payment of the tax will be shown in the Budget papers and will be subject to the Government's own on-going expenditure restraint guidelines and to Parliamentary scrutiny.
In addition, measures are to be taken to equate more closely the treatment of non-cash fringe benefits for Commonwealth public servants with that which is likely to apply to their counterparts in the private sector.
For example, the same rules that the Tax Office applies to private sector employees will be applied to public servants when apportioning the cost of Government provided home telephone services.
Commonwealth financed provision of credit cards to senior public servants is to cease forthwith and existing cards will not be renewed.
The private use of Commonwealth-owned

cars provided to employees will be stringently controlled.

With the introduction of this tax it is expected that some employers and employees may see advantage in replacing fringe benefits with cash payments.

As this would bring currently non-taxable benefits to book, such a development would be consistent with the Government's objectives in taxing these benefits.

The Government will consult with employers and the ACTU about possible adjustments to the wage fixing principles to provide for such "cashing-out" of benefits under appropriate conditions.

The Government does not expect, and would not wish to see, any further build-up in the provision of fringe benefits. The Government will review these arrangements, with a view to tightening their application, should any significant increases occur.

The tax will commence on 1 July 1986 and be paid quarterly, with the first payment due in October 1986.

The amount of tax revenue to be recouped is estimated at $320 million in 1986-87 and $515 million in 1987-88.

Living-away-from-home allowances

While most living-away-from-home allowances are not paid at excessive rates to avoid tax, there has been growing abuse in this area.

The Government has decided to tax the remuneration component of living-away-from-home allowances at the employer level in the same way as for non-cash fringe benefits, with effect from 1 July 1986.

The taxable value for this purpose will be equal to the amount of the allowance in excess of the proportion which represents reasonable compensation for additional expenditures on accommodation and on food.

The revenue gain is estimated at $10 million in 1986-87 and $15 million in subsequent years.

Entertainment expenses

One of the greatest difficulties in recent years in determining legitimate expense claims has been in the area of entertainment.

A good deal of so-called "business" entertainment tends to be done on a reciprocal basis and is often undertaken for predominantly social or personal benefit rather than business purposes.

In practice it is almost impossible for the Tax Office to separate those social activities from genuine commercial activities but it appears that the major part of expenses claimed have little or no genuine relevance to business activity.

It is the Government's view that the general public should not have to subsidise, through the tax system, the social activities of higher income earners who seek tax deductions for entertainment expenses.

Accordingly it has been decided to deny deductions for all entertainment expenses incurred after today.

Reflecting the lagged nature of business tax payments, this measure will produce $310 million in revenue in 1986-87 and $330 million in 1987-88.

The disallowance of deductions for entertainment will apply across-the-board and will include business meals, drinks, cocktail parties, tickets or boxes at sporting or theatrical events, sightseeing and hostess allowances.

It will include entertainment claimed to be associated with an advertising or promotional purpose, and it will cover the entertainment expenses of all taxpayers.

However, the measure cannot be directly applied to a tax exempt organisation which pays entertainment expenses which confer a personal benefit on its employees or associates or reimburses them for such expenses.

In such cases, it is intended that entertainment expenses be subject to the tax on non-cash fringe benefits.

Substantiation of expense claims

A deficiency of the existing law is that it does not specify the proof required to substantiate employment-related expenditure claims.

This results in successful claims for which there is no proof of expenditure.

To rectify this deficiency the Government has decided to amend the law to provide that deductions will not be allowable for expense claims unless the claimant is able to substantiate the amount and purpose of the claim by receipts or other documentary evidence.

All allowances above a certain limit, including independently arbitrated allowances, such as parliamentarians' electorate allowances, will be subject to substantiation.

More detailed substantiation requirements than for other expenses will generally apply in relation to car and travel expenses.

Moreover, deductions will not be allowed for the travelling expenses of a spouse on a business trip.

For self-employed people the new requirements will apply only to travel and vehicle expenses.

However, the rules will not apply to claims within the limits of employment-related travelling and accommodation allowances, provided that the travel is undertaken in Australia and the allowance is reasonable in amount.

Similarly, reasonable overtime meal allowances will be excluded.

Nor will the rules apply where total eligible expenses do not exceed $300.

With a 1 July 1986 commencement date, the estimated revenue in 1987-88 is $105 million, building to $200 million after about four years.

CAPITAL GAINS TAX

There has been a long debate in this country about the role of capital gains taxation – a debate which unfortunately has too often been characterised by misinformation and hysteria rather than rational discussion.

The Government believes that in inviting discussion about capital gains taxation in the draft White Paper the Australian community was finally offered an opportunity to consider the question of capital gains taxation in a more reasoned atmosphere.

The Government has decided to introduce a capital gains tax, but in the light of the public debate, to incorporate several major modifications to the proposal outlined in the White Paper in June.

These changes address the concerns which have been expressed and will substantially reduce the impact of the tax and allow the community a lengthy period in which to adjust to its application.

In particular, it has been decided that the tax will in every sense be prospective.

That means it will only apply to gains on assets purchased or acquired after today.

All assets already owned by taxpayers will be exempt from the tax when sold by them, both in respect of gains accrued until now and all future gains.

The Government has decided that the deemed realisation at death proposal, outlined in the draft White Paper, will not apply.

Liability for tax in the case of death will be rolled over to successors, and will only be assessed on any subsequent disposal.

Therefore the capital gains tax will not apply in the case of death.

Other main features of the tax include:

- it will only apply when the asset is sold or transferred by gift;
- it will only apply to real capital gains calculated by fully indexing the cost of the asset for inflation;
- a complete exemption will apply to gains on the taxpayer's principal residence and reasonable curtilage, on all motor vehicles, on other personal-use items such as furniture up to a sale value of $5,000, and on gains with respect to superannuation and the proceeds of life insurance policies;
- there will be provision for nominal losses to be offset against gains;
- the tax will be levied, on real gains, at ordinary rates of personal and company income tax.

The existing capital gains section (25A) of the income tax law will not apply in respect of assets acquired after today, but will continue to apply for assets acquired before midnight tonight.

The existing section 26AAA will continue to apply for all relevant assets.

Because of the wholly prospective nature of the tax, revenue is expected to build up gradually over a lengthy period, as newly-acquired assets are disposed of.

As an illustration of the fact that this tax will affect only a tiny section of the population, its expected revenue yield, in the fifth year of operation, is estimated to be only $25 million.

The tax will mean that, for assets acquired after midnight tonight, taxpayers will simply need to keep their records of purchase price, spending on improvements and sale price.

Valuation of assets already held will not be necessary, as all are exempt from the new provisions.

To cite an example; suppose an asset such as an office was purchased tomorrow for $100,000 and assume it is sold five years later for $130,000.

If during that five year period inflation totalled 25%, the gain would only be assessed as the difference between $130,000 and $125,000.

The gain of $5,000 would be taxed at the taxpayer's marginal rate which, in the case of a 40 cents in the dollar taxpayer, would amount to only $2,000 in tax.

I repeat, however, that every asset already owned by taxpayers will be exempt from the tax.

WHOLESALE SALES TAX

I announced on 13 August 1985 that the Government had decided against any major extension of the indirect tax base but would carry out a rationalisation of the existing wholesale sales tax schedules and rate structure.

As a result of this rationalisation, the rate structure is to be simplified, to reduce the existing four step scale to three.

These steps will be 10, 20 and 30%, in lieu of the existing 7½, 10, 20 and 32½% schedules.

The rationalisation will include the incorporation of the current 7½% category into the 10% category.

The rate for chocolates and other confectionary will be reduced from the current 20% to 10%, while the tax at that rate will be extended to close substitutes of the existing taxable items including snack foods, ice cream and biscuits.

Also to be taxed at 10% will be non-oil-burning domestic space heaters, domestic cooking stoves, domestic water heating systems, and wrapping materials for household use.

Each of those items is currently excluded from the sales tax base, a treatment inconsistent with that accorded almost every product of a similar kind.

The rate of tax on items currently subject to 32½% is to be reduced to 30% in the case of TV's, radios, videos and other electronic equipment, jewellery, furs, cameras, watches and clocks, cosmetics and perfumes and poker and amusement machines.

Other items currently taxed 32½% will fall to only 20% including pens, most brushes and shaving utensils, sound and video tapes and records.

A number of other anomalies and inconsistencies in the wholesale sales tax are being addressed, and details of all the changes are included in the attachment.

These charges will apply to goods passing the taxing point after midnight tonight.

Safeguarding measures will protect the revenue against any last minute transactions that attempt to avoid tax liabilities arising from the changes.

These measures are estimated to result in a net revenue gain of about $75 million in 1985-86 and about $110 million in a full year.

The estimated net effect of these changes in the CPI is very small at around 0.1 percentage points.

AUSTRALIA CARD

In order to combat tax evasion and reduce health and welfare fraud, the Government has decided to implement a national identification system involving the issue to individuals of a card – to be known as the Australia Card.

A companion system for entities such as companies and partnerships is also being developed.

Planning and development for the system will be completed over the next 18 months, and Australia Cards will be issued from March 1987.

The aim is to create an accurate register of all Australians which will contain only the most basic information, such as full name, address and date of birth.

It will assist the Government to verify records and payments – but it will do no more than that.

The privacy of every individual will be maintained.

People will need their Australia Card in only three situations – in connection with employment, conducting specified financial dealings and other matters with tax implications and when claiming Commonwealth benefits.

The Australia Card will help to ensure that everybody in the community contributes a fair share towards the costs of providing government services, and that no individual or group takes from the community more than their fair and equitable entitlements.

It is estimated that taxation revenue gains will amount to about $100 million in the first year of full operation of the system, expected to be 1989-90.

Revenue will rise to around $540 million per annum after the third full year of operation.

TAX-FREE THRESHOLD

The tax-free threshold is primarily intended to recognise the limited capacity to pay tax of low income earners who are required to support themselves for the whole of the year on that income.

In its present form the threshold provides an overly generous concession to part-year workers who are not wholly reliant for the full year on the taxable income returned.

The Government has decided that from 1 July 1986 the tax-free threshold will apply only on a pro-rata basis in the case of those taxpayers joining the Australian workforce on a full-time basis for the first time and to those leaving Australia permanently.

The full threshold will continue to apply to other taxpayers.

This measure is expected to yield around $90 million per annum from 1987-88.

PRESCRIBED PAYMENTS SYSTEM

Contrary to the alarmist claims made at the time of its introduction in 1983, the Prescribed Payments System has proved extremely successfull in combating tax evasion by contractors and sub-contractors in the building, transport, motor vehicle repair and cleaning, and other industries.

On the scheme's introduction, the 10% deduction rate that currently applies to payments by the relevant industries was set on a conservative basis in order to facilitate its implementation.

Having reviewed the arrangements, the Government has decided to increase the deduction rate from 10% to 15% from 1 July 1986.

As at present, those with a responsible tax record may apply to have this rate lowered where appropriate.

This measure will assist in countering evasion by applying a higher withholding rate to those payees who provide false information on deduction forms.

Also from 1 July 1986, owner-builders are to comply with full prescribed payments system requirements by making deductions from payments in connection with construction projects in excess of $10,000 that begin after that date.

The Government proposes to further review the operation of the prescribed payments system, including the desirability of extension to other industries.

The net revenue gain from these changes is estimated at $105 million in 1986-87 and $45 million in subsequent years.

QUARTERLY PROVISIONAL TAX

The existing system for the collection of provisional tax places stress on the money markets due to the substantial seasonal withdrawal of liquidity from the financial system in each June quarter.

To overcome this problem the Government has decided to introduce an instalment system for the payment of provisional tax by individuals, to commence in 1987-88.

When fully implemented, four instalments will be payable.

I emphasise that taxpayers will not be called upon to pay, in any financial year, a greater amount of tax than under the current system.

Self-assessment procedures will continue to ensure that taxpayers will not be required to pay an amount which exceeds their estimated net tax payable for the year.

The new system will not apply to taxpayers whose provisional tax liability does not exceed $2,000 – such taxpayers will continue to pay provisional tax on an annual basis.

This will exclude about three quarters of a million provisional taxpayers, about half of the total.

An alternative pattern of instalment payments with later due dates will be available to taxpayers, such as some primary producers, whose income flow is concentrated in the second half of the financial year.

The reduction in sales of Government securities that will result from this measure is estimated to generate interest savings of the order of $55 million annually from 1987-88.

QUARANTINING OF FARM LOSSES

One of the most heavily used tax shelters set out in the draft White Paper is the write-off of farm losses against income from another source.

The manner in which the tax system is currently structured allows other than genuine farmers to generate significant tax gains by directing investment to what otherwise would often be considered unprofitable ventures.

The proposed measure is along the lines of that canvassed in the draft White Paper, but with significantly more generous treatment of non-farm income.

The new rules will commence in the 1986-87 income year.

There will be two approaches.

The first will allow farm losses to be fully written off against non-farm income of up to $15,000 with a dollar for dollar shade-out for non-farm incomes between $15,000 and $30,000.

These thresholds will be subject to indexation.

The second approach will allow farm losses to be written off against non-farm income up to the aggregate of the previous five years net-farm income if this provides a greater write off.

This profitability test will cater appropriately for those cases where farm losses are caused by downturns and disasters, rather than tax sheltering activity.

Both approaches are designed to ensure that a genuine farmer who needs to take outside work to supplement farm income will in general not be adversely affected.

Revenue gains are estimated at $125 million in 1987-88 and $95 million annually thereafter.

Partly offsetting these revenue gains will be a significant improvement in the primary production averaging provisions.

An additional $20 million per annum benefit to farmers will arise from a complementary increase in the notional farm income limit for primary production averaging purposes, from the current level of $5,000 to the new level of $15,000.

This represents a significant increase in the amount of non-farm income which may benefit from the averaging provisions.

WATER CONSERVATION

The Government has decided to replace the immediate deduction currently allowed for expenditure by primary producers on conserving or conveying water with a write-off in equal instalments over 5 years.

The change will apply to expenditures incurred under contracts entered into after today.

Having regard to concerns expressed about land degradation problems, the Government has decided not to change the immediate 100% deduction currently allowed for expenditure on soil conservation.

The revenue savings are estimated at $25 million in 1986-87 and $20 million in 1987-88.

FILMS

The very generous tax treatment granted to the Australian film industry has in recent years led to a burgeoning cost to the revenue and to accompanying doubts about whether this subsidy is returning value for money.

The cost has grown from $13 million in 1981-82 to $135 million anticipated this financial year.

Consequently the Government has decided that the concessional treatment currently provided for film investments will be reduced to a 120% tax deduction and 20% income tax exemption for income.

This will apply to investments made under contracts entered into after today.

The grant to the Special Production Fund administered by the Australian Film Commission is to be increased from $4 million to $6 million in 1985-86, and to $7 million in 1986-87.

The estimated net saving to revenue of the changes are around $35 million in both 1986-87 and 1987-88.

PETROLEUM AND AFFORESTATION COMPANIES

As canvassed in the draft White Paper, the Government has decided to withdraw from midnight tonight the special rebate and deduction available for certain capital subscribed to petroleum and afforestation companies.

Revenue savings from these changes are estimated at $10 million for 1986-87 and $15 million for 1987-88.

INCOME TAX ON PUBLIC UNIT TRUSTS

The draft White Paper drew attention to the increasing use of trusts to avoid company tax.

Although the reforms to the company tax arrangements, which I shall mention shortly, will reduce the incentive to use trusts, there would still be advantages for tax-exempt institutional investors in the trust form.

The Government has therefore decided to extend company tax arrangements to public unit trusts, but only which operate a trade or business, as distinct from the great majority which are vehicles for investing in property, equities, or securities.

These latter public unit trusts, and all private trusts, will be unaffected by this measure.

The new arrangements will apply to trusts established after today to operate a trade or business.

There will be reasonable transitional arrangements to phase in the new treatment for existing trusts of that kind, with first company tax payments not required before 1988-89.

FOREIGN TAX CREDIT SYSTEM

Under current arrangements the income of Australian residents from foreign sources is generally exempt from income tax if it has been subject to tax overseas.

That exemption applies, however, regardless of how little that foreign tax may be.

As a consequence the Government has decided to replace the existing arrangements with a general foreign tax credit system along the lines set out in the draft White Paper.

Under the proposed system the foreign source income of Australian residents will be taxed in Australia and a credit for foreign tax paid will be allowed against Australian tax payable on that income.

Salaries and wages will generally remain exempt in Australia if taxable in the source country.

The new system, which is similar to systems operated by the United States, the United Kingdom and West Germany, will apply to income derived from the beginning of the 1987-88 income year.

I stress that, in proceeding with this measure, the Government will, through appropriate measures, give recognition to the position of regional countries that provide tax incentives to attract legitimate investment from Australia and elsewhere as a means of fulfilling their development aspirations.

The direct gain to revenue is estimated at about $45 million per annum at 1984-85 levels of income, with the first revenue gains accruing in 1988-89.

GOLD MINING

The draft White Paper proposal to tax income from gold mining has not been adopted.

An independent inquiry has been established to examine the impact of the White Paper proposal on the gold mining industry.

That inquiry will report to the Government during the first half of 1986.

TAXATION RELIEF

The measures I have announced will raise about $1 billion in 1986-87 and $1.7 billion in 1987-88.

As I stressed earlier the Government is engaged in a tax reform exercise, not a tax raising exercise.

Consequently, every dollar raised by these measures – and more – will be returned to taxpayers and social security beneficiaries by reform of the income tax rate scale and the company tax regime and by reductions in poverty traps.

I turn now to these proposals.

MINING

At present, excess deductions for exploration and development expenditure cannot be transferred to another company, even where the companies satisfy the 100% common ownership test.

Mining companies therefore cannot take full advantage of the group loss provisions available to other companies.

As canvassed in the draft White Paper, the Government has decided to extend that opportunity to petroleum and general mining companies.

This will apply to excess deductions from exploration and development expenditures incurred in 1985-86 and subsequent income years.

The estimated revenue costs of this measure are $70 million in 1986-87 and $65 million in 1987-88.

The Government also proposes to freeze, until the 1986-87 Budget, the difference between the diesel fuel excise and the diesel fuel rebate for diesel fuel used in mining operations.

The rebate will be further reviewed in the context of the 1986-87 Budget.

IMPUTATION SYSTEM OF COMPANY TAX

It has long been a complaint of taxpayers that dividend income is effectively taxed twice – once as company profits and once as personal income.

A further problem has been that the company tax rate is less than the maximum personal marginal tax rate.

This has provided an advantage for some higher income earners who can avoid the higher marginal tax rate by establishing companies for tax sheltering.

While the existing tax system provides a positive incentive for some people to channel income through companies, it effectively discourages most investors from buying shares altogether.

For decades the pattern of investment by Australians has been distorted away from productive enterprise owing to the double taxation of dividends.

The Government believes the raising of equity for our continuing national development should be encouraged.

Accordingly, the Government has decided to proceed with a system of full imputation on company income distributed to resident individual shareholders.

To help defray the cost of this measure, the company tax rate will be increased from 46% to 49%.

However, there will still remain a significant net cost of about $250 million per year to Commonwealth revenue.

People receiving dividends will receive a credit when they determine their own personal tax liability.

Thus, for each $51 of dividends received, $100 will be included in the shareholder's assessable income, and a credit of $49 allowed against the taxpayer's assessed income tax bill.

For a taxpayer with a marginal tax rate of 49%, this will effectively free the dividend from any tax.

Individuals facing lower marginal tax rates will be able to apply the excess credit to reduce their tax liability on non-dividend income.

The credit will not give rise to cash refunds where it exceeds tax otherwise payable.

Imputation credits will not extend to non-resident shareholders.

Because of the changes, some re-negotiation of Australia's double taxation treaties could be involved.

It is intended that the 49% company tax rate first apply to company tax collections in 1987-88 – that is, relevant to company incomes for the 1986-87 income year – and that imputation credits first apply to dividends paid in 1987-88.

On the basis indicated, the annual cost to revenue of these measures could be approximately $250 million from 1988-89.

POVERTY TRAPS

As part of the reform package, the Government has recognised that certain social security arrangements presently provide little incentive for pensioners and beneficiaries to earn extra income.

Accordingly, the Government will take a number of steps to alleviate the problems caused by these poverty traps.

First, from 1 November 1986, the amount of private income that a pensioner may earn before his or her pension is reduced under the income test will be increased by $10 per week for single pensioners and by $20 per week for pensioner couples.

This increases the amount single pensioners can earn each week, without affecting the pension, from $30 to $40 and for couples from $50 to $70.

As a result the pension payment received by all of the 450,000 recipients who currently receive a part-rate pension will increase by up to $5 per week.

Those pensioners earning in the range $30 to $40 per week may continue to face a small tax liability, but will no longer be subject to the 50 cents in the dollar income test as well.

Secondly, the Government will abolish the separate income test on rent assistance.

This test at the moment leads to the withdrawal of 50 cents in rent assistance for the first and each subsequent $1 of income earned.

The inclusion of rent assistance in the general income test will reduce the marginal rate of income withdrawal faced by some 700,000 pensioners and beneficiaries receiving rent assistance, in most cases from 50% to zero.

A benefit of up to $15 per week will flow to some 300,000 pensioners with non-pension income in private rental accommodations.

Thirdly, the Government proposes to further assist pensioners with children.

At present, the weekly income a pensioner may earn without reduction of pension is increased by $6 for each child.

This allowance is to rise to $12 per child.

The measure will increase the pension of all part-rate pensioners with children by up to $3 per week for each child.

All three measures will be introduced from the first pension and benefit payday in November 1986 as the tax reform measures begin to take effect.

The effects of the three measures I have announced may be illustrated by the case of a supporting parent or pensioner with 2 children living in a rental accommodation.

At present, if such a pensioner earned $100 a week of private income, the social security pension plus rent assistance is reduced by $44.

From November next year, this pensioner would lose only $18 in reduced benefits for a total gain of $26 a week.

The full year effect on outlays of the measures is estimated at about $215 million.

Net full year costs will be around $185 million as some part of the outlays will be clawed back in personal income tax in later years.

THE INCOME TAX RATE SCALE

Mr. Speaker, as I said at the outset, our major objective has been to substantially lighten the heavy weight of high marginal tax rates on honest taxpayers and to restore fairness to the operation of the taxation system.

That is what we set out to do.

With this reform package, that is what we will achieve.

The new tax schedules I will announce shortly have been framed with a number of factors in mind.

First, they represent the fulfilment of the Government's commitment to provide tax cuts from September 1986, equivalent to a 2% wage increase, as part of its agreement with the Australian Council of Trade Unions for continued wage restraint.

In addition, the tax cuts take account of the distributional impact of the reform measures that I have outlined.

These impact most heavily upon higher income earners; that is, the reform measures are highly progressive.

While that, of itself, does not establish a case for providing greater relief at such income levels, I come back to the point that reductions in the higher marginal rates have been, and remain, a prime objective of tax reform.

It is the high rates of personal income tax that have provided a major incentive for people to avoid and evade their tax and which involve the most severe disincentive to work, save and invest.

But few of the people in the top bracket have paid the 60% in the dollar asked of them.

They have arranged their affairs to evade, avoid or minimise that liability.

Instead their share of the burden has been carried by ordinary middle income Australians.

It must clearly be understood that the measures I have announced today will impact most heavily upon high income avoiders and evaders – those people will very definitely be worse off because of the Government's actions.

At the same time, when this package is implemented the Government of the Commonwealth of Australia will no longer be seeking to collect in income tax more than half the income of any citizen.

Mr. Speaker, the tax cuts that I will now detail have been timed to take effect as the extra revenue from our tax reform measures comes on stream.

On top of that, the Government fully recognises that the making of these tax cuts imposes very substantial constraints on future government spending proposals.

The following changes will be made to the personal income tax rate scale from 1 September 1986:

- the tax free threshold will be increased from $4,595 to $5,100, and the $12,500 threshold will be increased to $12,600;
- the 25% marginal rate will be reduced to 24%;
- the 30% marginal rate will be reduced to 29%;
- the 46% rate will be reduced to 43%;
- the 48% rate will be reduced to 46%; and
- the 60% rate will be reduced to 55%.

From 1 July 1987, by which time the revenue yield of the income tax base broadening measures will have built up significantly, the Government will complete the reform of the scales by making further reductions in the higher marginal rates.

Specifically:
- the 43 and 46% rates will be reduced to 40%; and
- the 55% rate will be reduced to 49%.

With the alignment of the top personal tax rate and the company tax rate at 49% from 1987-88, the special tax on excess profits retentions by private companies – the so-called Division 7 tax – will be unnecessary and will be removed.

Further details of these tax cuts, and their impact on various categories of taxpayers, are included in the Attachments (not reproduced here).

CONCLUSION

Mr. Speaker, what I have announced today are far-reaching genuine, and substantial tax reforms.

They achieve the fundamental objectives we set ourselves at the outset of this ambitious endeavour, namely:
- to significantly reduce marginal tax rates;
- to curtail tax avoidance and evasion and restore fairness to the tax system; and
- to gear our system for economic growth by providing greater rewards for initiative, removing distorting shelters and ending the double taxation of dividends.

The Government's tax reform exercise is completed.

We will, however, continue to act where necessary to stamp out any avoidance and evasion practices that develop.

Furthermore, the package I have announced today commits the Government to unprecedented fiscal responsibility over the years ahead.

Mr. Speaker, in bringing down this package the Government has confronted the issue of tax reform.

We have been willing to consult with the people of Australia.

We have been willing to seriously and responsibly consider the issues involved.

And we have been willing to take hard decisions.

These decisions are essential to secure the future economic well-being of the Nation.

They are essential if we are to recover respect and integrity for the taxation system.

They are essential if all Australians are to be treated with fairness and with equity.

The Government is confident the people of Australia will recognise that these significant measures are taken in the best interests of the Nation and for the greater good of every individual Australian.

In next issues:

Korean People's Democratic Republic: Executive Decree concerning the Joint Venture Act.

Bangladesh: Depreciation allowances under the Income-tax Ordinance, 1984 – A summary
by *K.A. Gofran*

European Communities: Financing the Community

Taiwan: An outline of the proposed value added tax system
by *Jap Kim Siong*

India: Is tax avoidance merging into tax evasion?
A change in the judiciaries' approach to tax avoidance
by *Parimal M. Parikh*

The Zimbabwe 1985 Budget
by *D.G. Murphy*

U.S.A.: New Delaware law facilitates failsafe planning
by *William S. Conely* and *William G. Dodge*

Nigeria: Reforming sales tax in developing countries:
A study of the Nigerian Sales Tax System
by *Mahesh C. Purohit*

news

Resolutions London IFA Congress 1985

At the end of the 39th IFA Congress in London (8-13 September 1985) the following resolutions were adopted. Note that the Resolution on Subject I was originally drafted in English and the Resolution on Subject II was drafted in French. An English translation of the latter Resolution is included in the text below.

SUBJECT I: The assessment and collection of tax from non-residents

RESOLUTION (original version)

CONSIDERING THAT

A. Non-resident individuals and corporations supply useful labour, enterprise, skill, technology and other resources, with beneficial consequences for the economic well-being of the countries in which they work or invest their resources or with which they carry on business.

B. Nevertheless a non-resident person who derives income, profits or capital gains from sources in a country, or possesses capital situated in a country, should pay an appropriate share of that country's taxation of such objects and should conscientiously comply with the tax obligations placed upon him in that country.

C. At the same time, tax administrations may have special difficulties in ascertaining the basis for the tax liability of a non-resident, in imposing tax upon him and in enforcing his tax obligations, due to such factors as:

(i) the absence of the non-resident person from the local jurisdiction;
(ii) the greater difficulty of acquiring adequate information as to the activities of the non-resident person, either inside or outside the local jurisdiction, his relevant personal circumstances or his tax deductible expenditures;
(iii) the absence of local representatives against whom, or assets against which, the tax liability or other tax obligations can be enforced.

D. On the other hand, a non-resident person may, for similar reasons to those mentioned previously, suffer unduly burdensome, arbitrary or discriminatory taxation and, because of the taxation which he is called upon to pay in his home country on the same income, profits, capital gains or capital, may suffer unrelieved double taxation.

E. In addition, a non-resident person may experience greater difficulties than a resident person in discovering what his tax obligations may be and in complying satisfactorily with them because of his absence from the country and unfamiliarity with the local language, laws and customs of the host country and his need, in many cases, to conduct his operations through local contacts, representatives or agents.

F. In the light of the above considerations, it is essential that countries should seek to achieve a balance between the requirements of the non-resident person and those of its tax collection and administration.

THE XXXIXth CONGRESS OF THE IFA RECOMMENDS:

1. The obstacles to international trade, freedom of investment and the movement of labour, skills or technology across international frontiers, which may otherwise be created by unnecessarily burdensome, arbitrary or discriminatory taxation of non-residents, should be minimised.

2. In establishing any regime for the taxation of non-resident persons, countries should take account of the principle of international mutual respect. Accordingly, they should apply standards of equity and general tax policy no less favourable than those applied to resident persons and should give due consideration to the effects of their taxation on the non-resident person who may also be liable to tax in his country of residence on the same income or gain.

3. The liability to taxation of a non-resident person on income, profits, capital gains and capital should be limited to the taxation of the income, profits and capital gains arising from sources and capital situated in the host country.

4. If not exempt, a non-resident taxpayer should be taxed as far as practicable on the same basis as a resident person, due account being taken of the differences between his situation and that of a resident, and giving the non-resident the same rights of appeal as a resident person. To that end, where arbitrary tax bases or rates of tax would otherwise be applied, including the imposition of tax on gross revenue without the allowance of a deduction for related expenses, a non-resident person should be allowed the option of establishing his liability to tax on the true measure of the income, profits or gain at the rate applicable to resident persons. In doing so, unnecessary administrative or other difficulties should not be put in his way and any excessive tax paid should be refunded as soon as possible.

5. Tax authorities should ensure, so far as necessary and practicable, that

(a) a non-resident person who is an actual or potential taxpayer can conveniently acquaint himself with his likely actual or potential tax obligations, the circumstances in which these would arise, the time limits for rendering returns, the accounts and documents required by the administration, the rights and conditions of appeal or claim to repayment and the penalties for failure to comply with obligations;
(b) that the relevant law is as simple and certain as possible;

(c) that the administration of the tax law, as well as being honest and fair, is effective and speedy both in enforcement of the non-resident's tax obligations and in the protection of his rights, and
(d) that, as well as cooperating with other tax authorities across international borders for the more effective enforcement of the tax obligations of taxpayers, tax authorities should cooperate to ensure that non-residents may enjoy the appropriate rights, privileges, reliefs and reductions of taxes which are due to them.

6. Business profits arising to a non-resident person should be taxed only to the extent that they arise from a permanent establishment situated in the country. The Conference in its majority approves the concept of permanent establishment, like that of the OECD Model Double Taxation Convention on Income and on Capital. Profits as well as expenditure should be allocated to the permanent establishment on the arm's length basis.

7. Income from securities and properties, such as dividends, interest, royalties, rents, may be taxed by the withholding tax method but the rate at which tax is withheld should not be excessive and should reflect the fact that the tax is levied on a gross amount of income. The procedure under which the tax is withheld should enable the withholding agent to recognise and comply with his obligations while incurring reasonable constraints and costs. It should not give rise to difficulties to the withholding agent by, for example, requiring him to breach any obligation of confidentiality. The procedure for levying withholding tax should facilitate the recovery of any tax wrongly deducted.

8. Specific care is required in the taxation of income from dependent personal services. The personal deductions and expenses incurred by a non-resident taxpayer should be taken into account in the same manner and to the same extent as such deductions and expenses incurred by a resident person.

9. Income from independent personal services should be taxed on a net basis. The principles to be applied in the taxation of business profits arising from a permanent establishment should apply equally in these circumstances.

10. The capital gains of a non-resident person derived from sources situated in the country concerned when the gain arises, if not exempt, should be taxed no more heavily than the capital gains arising to a resident person.

11. Tax authorities should seek to prevent, or grant relief from, any double or excessive taxation of income or gains of non-resident persons, even when a double taxation treaty does not exist. The terms of the treaties should be arrived at with due importance given to the desirability of protecting the interests of the non-resident in the area of taxation, as well as protecting the revenues of the Contracting States and those States should cooperate under the treaties with these objectives in mind.

SUJET II:
La double imposition internationale des successions et des donations

RESOLUTION (version originale)

1. Considérant l'extraordinaire diversité des impôts sur les successions et les donations dans les divers pays du monde, et observant aussi les allègements unilatéraux accordés par quelques pays en ce qui conçerne l'imposition internationale multiple, ce congrès considère qu'un tel allègement n'est vraisemblablement pas capable d'éliminer les sérieux problèmes d'imposition multiple et il exprime sa forte approbation à l'égard des efforts faits pour encourager la négociation de traités bilatéraux, ou, si possible, multilatéraux, pour éviter de telles taxations multiples.
2. Ce congrès appelle tous les pays à augmenter leurs efforts pour négocier des conventions basées substantiellement sur le modèle de convention de l'OCDE de 1982 sur les doubles taxations sur les successions et les donations, incluant à la fois les taxes fédérales et les taxes locales et comprenant en particulier les principes suivants:
   (a) dans les cas où plusieurs pays pourraient autrement réclamer le droit de taxer sur la base du domicile du de cujus ou du donateur situé sur leur territoire, en définissant un seul domicile pour cette personne selon les règles de l'article 4 de la convention modèle;
   (b) en limitant le droit de chaque pays de taxer les successions et les donations sur la base du situs des biens herités ou reçus en donation situés sur son territoire aux biens immobiliers et aux établissements stables;
   (c) en définissant si les intérêts dans une société de personnes ou dans un trust, qui possède un bien immobilier ou un établissement stable, doivent être assimilés à la propriété directe de ces biens;
   (d) en accordant la déduction des dettes du de cujus essentiellement selon les règles de l'article 8 de la convention modèle;
   (e) en accordant un allègement fiscal adéquat par le pays dans lequel le bien immobilier ou l'établissment stable du de cujus ou du donateur n'est pas situé, soit par une exemption, soit par un crédit d'impôt (sur la base d'un crédit pays par pays ou d'un crédit global, au choix du contribuable), pour les impôts sur la succession ou les donations levés par le pays du situs de ces biens;
   (f) en reconnaisant le droit des pays qui établissent leur juridiction fiscale sur la base de la citoyenneté du de cujus ou du donateur, de continuer à prélever de telles taxes, pourvu que ces pays donnent un allègement adéquat, soit par une exemption, soit par un crédit d'impôt, pour toutes les taxes levées par les autres pays qui établissent leur juridication fiscale sur la base du domicile du de cujus ou du donateur;

(g) en reconnaissant le droit des pays qui établissent leur juridiction fiscale sur la base de la citoyenneté ou du domicile de l'héritier ou du donataire de continuer à lever de telles taxes, pourvu que ces pays donnent un allègement adéquat, soir par une exemption, soir par un crédit d'impôt pour toutes les taxes levées par les pays qui établissent leur juridiction fiscale sur la base de la citoyenneté ou du domicile du de cujus ou de donateur.

3. En attendant la conclusion des conventions évitant la taxation internationale multiple, ce congrès demande à tous les pays d'adopter des mesures unilatérales s'inspirant des principes ci-dessus et apportant un allègement adéquat contre la taxation international multiple.

[English version]

SUBJECT II:
International Double Taxation of Inheritances and Gifts

RESOLUTION

1. Noting the extraordinary diversity of inheritance and gift taxes among the countries in the world and noting also the unilateral relief provided by some countries in respect of international multiple taxation, this Congress considers that such relief is unlikely to eliminate serious problems of multiple taxation and expresses its strong support for efforts to encourage the negotiation of bilateral or possibly multilateral conventions for the avoidance of multiple taxation.
2. This Congress calls on all countries to increase their efforts to negotiate conventions based substantially on the 1982 OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts including both federal and state or local taxes where applicable, and incorporating in particular the following principles:
   (a) in those cases in which more than one country might otherwise claim taxing jurisdiction on the basis of the domicile of a decedent or donor within its territory, determining in accordance with the rules of Article 4 of the Model Convention;
   (b) limiting the right of each country to tax inheritances and gifts solely on the basis of the situs of the inherited or gifted property within its territory to (i) immovable property and (ii) permanent business establishments situated there;
   (c) determining whether or not ownership of a partnership interest, or of an interest in a trust, which owns immovable property or, a permanent business establishment, is to be regarded as equivalent to ownership of such property;
   (d) allocating the debts of a decedent between the countries substantially in accordance with the rules in Article 8 of the Model Convention;
   (e) providing adequate tax relief by the country in which the immovable property or permanent business establishments of a decedent or donor are not situated, either by exemption or by tax credit (on a country-by-country or on a global basis, at the taxpayer's election) in respect of inheritance and gift taxes levied by the country of situs of such property;
   (f) recognizing the right of those countries which assert taxing jurisidiction on the basis of the decedent's or donor's citizenship to continue to levy such taxes, provided they give adequate relief, either by exemption or tax credit, for all taxes levied by the other country, which asserts taxing jurisdiction on the basis of the decedent's or donor's domicile; and
   (g) recognizing the right of those countries which assert taxing jurisdiction on the basis of the beneficiary's or donee's citizenship or domicile to continue to levy such taxes, provided they give adequate relief, either by exemption or tax credit, for all taxes levied by the country which asserts taxing jurisdiction on the basis of the citizenship or domicile of the decedent or donor.
3. Pending the conclusion of conventions for the avoidance of international multiple taxation this Congress calls on all countries to enact unilateral measures reflecting the above principles and providing adequate relief against international multiple taxation.

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